

Summer 1997

Conflicts of Interest in Workouts and Bankruptcy Reorganization Cases

Gerald K. Smith
Lewis and Roca LLP

Follow this and additional works at: <https://scholarcommons.sc.edu/sclr>



Part of the [Law Commons](#)

Recommended Citation

Gerald K. Smith, Conflicts of Interest in Workouts and Bankruptcy Reorganization Cases, 48 S. C. L. Rev. 793 (1997).

This Article is brought to you by the Law Reviews and Journals at Scholar Commons. It has been accepted for inclusion in South Carolina Law Review by an authorized editor of Scholar Commons. For more information, please contact dillarda@mailbox.sc.edu.

CONFLICTS OF INTEREST IN WORKOUTS AND BANKRUPTCY REORGANIZATION CASES

Gerald K. Smith*

I.	INTRODUCTION	794
II.	CONFLICT RULES FOR THE TWENTIETH CENTURY	810
A.	<i>Bankruptcy Code Conflict Rules</i>	812
B.	<i>Other Rules of Professional Conduct Applicable in Bankruptcy Courts</i>	827
C.	<i>American Bar Association Rules of Professional Conduct</i>	832
D.	<i>Restatement (Third) of the Law Governing Lawyers</i> .	838
III.	CONFLICTS IN WORKOUTS AND REORGANIZATION CASES	
IDENTIFIED AND ANALYZED		851
A.	<i>Representing a Debtor in a Workout when a Creditor Is a Client in an Unrelated Matter</i>	851
B.	<i>Representing a Debtor in a Workout when a Creditor Is a Former Client</i>	858
C.	<i>Representing the Debtor or Creditors in Initiating a Chapter 11 Case when the Lawyer Represents or Represented a Creditor in an Unrelated Matter</i>	860
D.	<i>Representing a Debtor-in-Possession or Trustee When a Party-in-Interest is a Client in an Unrelated Matter</i>	863
E.	<i>Representing Multiple Parties-in-Interest in a Chapter 11 Case</i>	869

* Partner, Lewis and Roca LLP. B.S. Kansas State University (1958); LL.B. New York University (1961, Root-Tilden Scholar and Articles and Survey Editor, *New York University Law Review*, 1960-1961); Member, National Bankruptcy Conference; Deputy Director, Commission on the Bankruptcy Laws of the United States (which produced the first draft submitted to Congress of the current Bankruptcy Code); Member, Advisory Committee on Rules of Bankruptcy of the Judicial Conference of the United States; Member, Partnership Working Group and Ethics Working Group of the National Bankruptcy Review Commission; Member and former Chairman of the Board of Directors and Board of Regents, American College of Bankruptcy Professionals; Member, American Law Institute; Advisor, Article 9 Study Committee; Advisor, Transnational Insolvency Project; Former Lawyer Delegate, Ninth Circuit; Member, ABA Business Section Ad Hoc Committee on Partnerships; Member and former Chairman, ABA Business Section's Business Bankruptcy Committee's Ethics Subcommittee; Participant in the Special Study Conference on the Federal Rules Governing Attorney Conduct of the Judicial Conference of the United States.

F.	<i>Representing Affiliates in a Chapter 11 Case</i>	875
G.	<i>Representing Parties in Interest with Inconsistent Positions: Positional Conflicts</i>	877
IV.	CONFLICT RULES FOR THE TWENTY-FIRST CENTURY	881

I. INTRODUCTION

A professional employed by a trustee or debtor-in-possession in a reorganization case under Chapter 11 of the Bankruptcy Code¹ must be free of any interest adverse to the estate.² The Bankruptcy Code defines neither

1. 11 U.S.C.A. §§ 101-1330 (1994 & Supp. 1997).

2. 11 U.S.C.A. § 327(a) (1994). Although this article concerns conflicts of professionals employed by the trustee or debtor-in-possession, a brief description of the provisions regulating employment of professionals by committees seems useful. The Bankruptcy Code disqualifies attorneys and accountants who represent someone with "an adverse interest in connection with the case," 11 U.S.C. § 1103(b), but representation of one or more creditors of the same class as represented by the committee is not per se the representation of an adverse interest. *Id.* But another provision of the Bankruptcy Code allows the court to deny compensation to a professional employed by the committee who is not disinterested as well as one who "represents or holds an interest adverse to the interest of the estate with respect to the matter on which such professional person is employed." 11 U.S.C. § 328(c). It is implicit in § 328(c) that counsel for the committee must be disinterested as well as free of adverse interests. The original version of § 1103(b) provided that "a person employed to represent a committee appointed under § 1102 of this title may not, while employed by such committee, represent any other entity in connection with the case." Bankruptcy Reform Act of 1978, Public Law 95-598, 92 Stat. 2549. This precluded a professional from simultaneously representing a committee and anyone else in connection with the same bankruptcy case. According to the legislative history, it was primarily designed to avoid the possibility of conflicting demands on counsel when the committee position differed from that of the other client—party in interest. It did not seek to prevent representational influences impacting counsels independence otherwise. H.R. REP. NO. 595, 95th Cong., 1st Sess. 105 (1977). As amended by § 500(a) of the Bankruptcy Amendments Act of 1984, § 1103(b) no longer precludes a lawyer or accountant from representing a committee in the case while simultaneously representing in the case one or more creditors of the same class as the class represented by the committee. Can a lawyer or accountant represent the committee if the lawyer or accountant represents a party in interest other than a creditor or a creditor of a different class than the class represented by the committee? Section 324 of the 1984 amendment also substituted "attorney or accountant" for "person." This was done to eliminate any inference that a nonattorney or nonaccountant could represent a committee. Does this mean that the exception only applies to attorneys and accountants? This article leaves to another occasion a discussion of the employment of professionals by committees.

adverse interest nor estate.³

The term adverse interest was not used in the Bankruptcy Act of 1898⁴ until introduced as part of the definition of disinterestedness by the Chandler Act Amendments of 1938.⁵ Prior to that, the employment of counsel for a trustee was regulated by General Order 44 which precluded employment of an attorney representing an interest adverse to the trustee or the estate in the matters on which the attorney was to be engaged and which required that the attorney make appropriate disclosures.⁶ However, General Order 44 did not define or elaborate upon what was an interest adverse to the trustee or the estate. Effective October 1, 1973, General Order 44 was abrogated and replaced in liquidation cases by Bankruptcy Rule 215(a) which closely tracked General Order 44 and conditioned employment of an attorney on the attorney holding no interest adverse to the estate in the matters upon which he was to

3. Bankruptcy Code § 541 is entitled "Property of the Estate," but contains a laundry list of not only what is but also what is not property of the estate. 11 U.S.C. § 541. Bankruptcy Code § 542 is entitled "Turnover of Property to the Estate," but instead it requires turnover of property of the estate to the trustee. 11 U.S.C. § 542(a).

The identification of the assets subject to the Bankruptcy process is expressed in the concept of "property of the estate." At the moment the Bankruptcy petition is filed, under section 541 of the Code, an "estate" is created automatically (the customary phrase is "by operation of law"). The Bankruptcy estate is a new legal entity, like a new corporation or trust, able to own property, to conduct business, and to sue and be sued. This legal person, the estate, becomes the transferee and new owner of every conceivable interest that the Debtor may have had in any kind of property whatsoever at the moment of Bankruptcy, including future interests and contingent or conditional interests of any kind. This entity has the right to gather and sell all such property and, from the proceeds, to distribute funds to creditors according to the statutory priorities. The estate steps into the shoes of the Debtor, having the same rights against other parties and being subject to the same defenses and claims. In addition, the estate has the benefit of the Avoiding Powers, discussed below. In contrast to the Canadian concept, it is the estate, not the Trustee in Bankruptcy individually, that is the transferee of title to the assets. The Trustee's powers in the United States come from being the manager of the estate. By the same token, the Trustee in the United States is rarely liable personally for post-Bankruptcy obligations, which are obligations of the estate.

ALI Transnational Insolvency Project (Tentative Draft, April 15, 1997), pp. 25-26.

4. Bankruptcy Act of 1898, ch. 541, 30 Stat. 544.

5. Act of July 22, 1938, ch. 575, 52 Stat. 840.

6. 4B COLLIER ON BANKRUPTCY 1543 (James Wm. Moore & Lawrence P. King eds., 14th ed. 1978).

be engaged.⁷ This was a significant change in the conflict standard for liquidation cases.

The word "estate" has been substituted in lieu of the reference in this sentence of the general order to "the receiver, trustee, creditors or stockholders." The interests of stockholders may not be identical to those of the receiver, trustee, or creditors, but insofar as the interests of the estate may not embrace those of stockholders, the substitution of the less comprehensive term is not objectionable. The representation or holding of an undisclosed interest in no way adverse to the estate should afford the court no basis for denying compensation to an attorney . . . because the interest is adverse to the stockholders. Indeed, effective representation of a trustee or receiver by an attorney seems likely to run counter to the interests of the stockholders in a considerable number of cases, and such representation should not be discouraged by these rules.⁸

This animus toward stockholders in liquidation cases was not applicable to reorganization cases since the liquidation rule of Bankruptcy Rule 215 was overridden by the disinterestedness standard in Chapter X reorganizations. That standard was even handed and required that the person to be employed not have "an interest materially adverse to the interests of the estate or of any class of creditors or stockholders."⁹

Since there is no definition of adverse interest in the Bankruptcy Code, bankruptcy judges have struggled with its meaning and application. In *In re Roberts*,¹⁰ Judge Glen Clark defined conflict of interest as "representation by a given attorney or law firm of two or more entities holding or claiming adverse interests or of an entity holding an interest adverse to that of its attorney, its attorney's firm or the firm's associates."¹¹ This approach is inadequate since it does not focus on the real issue, the adequacy of the representation. The case foundered on actual versus potential conflicts and

7. BANKR. R. 215(a) (Law Co-op. 1974).

(a) *Conditions of Employment of Attorneys and Accountants.* No attorney or accountant for the trustee or receiver shall be employed except upon order of the court. . . . If the attorney or accountant represents or holds no interest adverse to the estate in the matters upon which he is to be engaged, and his employment is in the best interest of the estate, the court may authorize his employment. Notwithstanding the foregoing sentence, the court may authorize the employment of an attorney or accountant who has been employed by the bankrupt when such employment is in the best interest of the estate.

Id.

8. BANKR. R. 215, Advisory Committee's Note (Law Co-op. 1974).

9. Chapter X § 158, Collier Bankruptcy Act and Rules, Part 1 (1976), p. 307

10. 46 B.R. 815 (Bankr. D. Utah 1985), *aff'd in part*, 75 B.R. 402 (D. Utah 1987).

11. *Id.* at 827. See 1 WILLIAM J. NORTON, JR., BANKRUPTCY LAW AND PRACTICE § 25:3.05 (2d ed. 1996), for additional cases defining the term.

unnecessarily complicated matters by applying the Model Code's appearance of impropriety standard. In sharp contrast, in *In re Leslie Fay Companies, Inc.*,¹² Judge Tina Brozman squarely addressed the issue of adequacy of the representation by finding an adverse interest "if it is plausible that the representation of another interest may cause the debtor's attorney to act any differently than . . . without that other representation."¹³

In *In re Kendavis Industries International, Inc.*,¹⁴ Judge Harold Abramson also focused on the adequacy of the representation:

This rule requires that an attorney not place him or herself in a position where he or she may be required to choose between conflicting loyalties. . . . Representation of a shareholder, officer or director of a debtor corporation led to a situation in this case where Locke Purnell's ability to exercise independent judgment on behalf of its client, the Debtors, was impaired.¹⁵

Judge Abramson disagreed with the concept of "potential conflict,"¹⁶ but created a *per se* rule disqualifying a lawyer from representing a corporation as a debtor in possession in a bankruptcy case if the lawyer represents a person in control of a corporate debtor.¹⁷

Judge Jack Schmetterer in *In re American Printers & Lithographers, Inc.*,¹⁸ recognized the logic of rejecting the distinction between potential and actual conflicts, but found Judge Abramson's approach "contrary to the well established rule against the formulation of bright-line *per se* rules of disqualification."¹⁹ Nonetheless, Judge Schmetterer disqualified the law firm

12. 175 B.R. 525 (Bankr. S.D.N.Y. 1994).

13. *Id.* at 533.

14. 91 B.R. 742 (Bankr. N.D. Tex. 1988).

15. *Id.* at 752-53 (citation omitted).

16. *Id.* at 754. "The concept of *potential* conflicts is a contradiction in terms. Once there is a conflict, it is *actual—not potential*." *Id.*

17. *Id.*

To make the Court's holding more concrete, the Court holds that whenever counsel for a debtor corporation has any agreement, express or implied, with management or a director of the debtor, or with a shareholder, or with any control party, to protect the interest of that party, counsel holds a conflict. That conflict is not potential, it is actual, and it arises the date that representation commences. This holding would apply equally to partnerships. An attorney who claims to represent a partnership, but also has some agreement, whether express or implied, with the general or limited partners, or with any control person, to protect its interest, that attorney has an actual conflict of interest, and is subject to disqualification and a disallowance of fees.

Id.

18. 148 B.R. 862 (Bankr. N.D. Ill. 1992).

19. *Id.* at 866.

in *American Printers* since he found there was a high likelihood that the potential conflict would become an actual conflict and “no compelling reason which calls for this Court to set aside the general disfavor of authorities toward employment of professionals with potential conflicts,”²⁰ particularly when “it has not been shown that the pool of potential counsel available to debtor does not supply available skilled counsel.”²¹

However, with an earlier nudge from the District Court, Judge Charles Matheson rejected the potential conflict concept in *In re Amdura Corp.*²² In *Amdura*, Judge Matheson held the representation of a major creditor of Amdura in unrelated matters was an actual conflict since the relationship of the client to the lawyer adversely affected the ability of the lawyer to represent the interests of the debtor-in-possession.²³

The Fifth Circuit adopted a per se rule in *In re W.F. Development Corp.*,²⁴ holding that one attorney could not represent both limited and general partners in a bankruptcy case.²⁵ The court relied not on Judge Abramson’s

20. *Id.* at 867.

21. *Id.*

22. 121 B.R. 862, 868 (Bankr. D. Colo. 1990). In *Amdura* Judge Matheson referred to the District Court’s opinion in *Colorado National Bank v. Genco, Inc.* (*In re Genco, Inc.*), 105 B.R. 620 (D. Colo. 1988), which reversed his holding in that case recognizing a distinction between actual and potential conflicts.

The District Court in *Ginco* set aside the order of appointment. Citing section 327 of the Code, the court noted the stringent adverse interest test imposed by the statute when it stated:

An attorney may not “hold or represent an interest adverse to the estate” in any matter. In the pending state litigation FMTG [the attorney] already represents Richard Ginder—the principal shareholder, officer and debt-guarantor of the corporation. Mr. Ginder may have an equity interest in Ginco and is a potential target for claims of corporate mismanagement. Under those circumstances, dual representation by FMTG of the estate and Mr. Ginder is a sufficient conflict to be an adverse interest under both subsection (a) and subsection (e). *Ibid.* at 621.

The court rejected the concept of distinguishing between an actual present conflict and a potential conflict. The court admonished that the literal language of the Bankruptcy Code must be respected and followed.

The District Court’s opinion in *Ginco* may have been softened somewhat by the opinion of Chief Judge Finesilver in the *Matter of W.V.S. Investment Joint Venture*, Civil Action No. 89-F-331 (D.Colo. January 4, 1990), but only to the extent of saying that an attorney can represent dual clients where their interests are common in the matter for which the attorney is retained.

Amdura 121 B.R. at 866.

23. *Amdura*, 121 B.R. at 869.

24. *W.F. Dev. Corp. v. Office of the U.S. Trustee (In re W.F. Dev. Corp.)*, 905 F.2d 883 (5th Cir. 1990).

25. *Id.* at 884.

analysis in *Kendavis*, but on Bankruptcy Judge Samuel Bufford's analysis in *In re McKinney Ranch Associates*.²⁶

Because of his fiduciary duties, a general partner of a limited partnership will always be a potential target of claims by a limited partnership debtor. A general partner is responsible for the day to day affairs of the business, and makes the policy decisions that lead to the financial problems that result in bankruptcy. This may involve a breach of fiduciary duty or securities law violations. The general partners may have received preferential or fraudulent transfers, or have received property of the estate. In addition, a general partner may have given a guaranty of the partnership debts. Counsel for the debtor will likely be required to examine the relations between the partnership and its general partners for possible claims against them. Thus the potential conflict in the representation of a general partner of a limited partnership will always disqualify an attorney from simultaneously representing the limited partnership as a debtor in possession or from representing the trustee of a limited partnership.²⁷

The Bankruptcy Code also requires that professionals be disinterested. This standard precludes employment of professionals who hold or represent certain interests. This approach to independence originated with the work of the Protective Committee Study and then Securities and Exchange Commissioner William O. Douglas's revisions to the Chandler Act Amendments.²⁸ The key reform urged by the Securities and Exchange Commission was the appointment of a disinterested trustee. The Protective Committee Study delved deeply into the techniques of protective committees and conflicts of interest in reorganization cases.²⁹ Those conducting the investigation concluded that the objectives of management and underwriters were alien to matters of fairness and instead introduced "in every large situation of management and underwriters, with objectives, among others, of continued control, affiliation, and perpetuation in office, and the preservation of common stock interests. . . . [T]hese forces have tended to make irrelevant the other considerations"³⁰ of

26. 62 B.R. 249 (Bankr. C.D. Cal. 1986), *cited in* *W.F. Dev. Corp.*, 905 F.2d at 884.

27. *McKinney*, 62 B.R. at 255-256. Judge Bufford apparently was not troubled by the fact that the general partner managed the partnership and controlled the work performed by counsel.

28. Act of July 22, 1938, ch. 575, 52 Stat. 840.

29. *See* SECURITIES & EXCH. COMM'N, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES PART VIII 8 (1940). One of the criticisms leveled at section 77B was its failure to require "complete disinterestedness," *id.* at 104, on the part of a trustee. Another was that in most cases initiated under section 77B in 1936 the debtor continued in possession and management of the corporation. The Report pointed out that this was anomalous; "in ordinary bankruptcy . . .

30. SECURITIES & EXCH. COMM'N, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES PART VIII 8 (1940). One of the criticisms leveled at section 77B was its failure to require "complete disinterestedness," *id.* at 104, on the part of a trustee. Another was that in most cases initiated under section 77B in 1936 the debtor continued in possession and management of the corporation. The Report pointed out that this was anomalous; "in ordinary bankruptcy . . .

soundness of corporate structure and fairness. With the advent of the 1978 Bankruptcy Code, Congress increased the powers and privileges of management many fold, and scrapped the independent trustee, the assurance of a fair reorganization, in most cases.³¹

Because of the continuance of the debtor or its prepetition management in control in most cases, the requirement that the lawyer representing the interested debtor be disinterested is anomalous. This caused the Professional Ethics in Bankruptcy Cases Subcommittee of the Business Bankruptcy Committee of the Business Section of the American Bar Association ("Business Bankruptcy Ethics Committee")³² to seek a resolution of the American Bar Association supporting an amendment to the Bankruptcy Code to apply state ethical rules to the employment of counsel for the debtor-in-possession rather than the disinterestedness standard. In 1991, the American Bar Association House of Delegates passed such a resolution.³³ Although a matter of importance, the propriety of the application of the disinterestedness standard to counsel for the debtor-in-possession is not the subject of this article.³⁴

[a trustee] was mandatory," *id.*, and "in equity proceedings a receivership without a receiver would have been an anomaly." *Id.* at 104-05. In commenting on the qualification of trustees in bankruptcy cases, the Report stated that:

[T]he federal courts in ordinary bankruptcy proceedings frequently have withheld their approval of the trustees elected by creditors because of the trustees' lack of disinterestedness—a lack attributable to the trustees' affiliation with persons having interests adverse to those of the estate. Although the rule in bankruptcy has not been inflexible, a conflicting interest or association sufficient to impel judicial disapproval of the trustee elected by creditors has been found in a direct or indirect connection with the bankrupt, the receiver of the bankrupt, the bankrupt's assignee for the benefit of creditors, and creditors whose claims are in dispute.

Id. at 105.

31. See 11 U.S.C. §§ 1103, 1107 (1994).

32. The Committee was initially a Task Force created by the Chair of the Business Bankruptcy Committee, Nathan B. Feinstein, who has had a longtime interest in ethics and ethics in bankruptcy cases in particular. The original officers of the Business Bankruptcy Ethics Committee were Gerald K. Smith, Chair, Myer ("Mike") O. Sigal, Vice-Chair and Susan M. Freeman, Reporter. Myron ("Mickey") M. Sheinfeld succeeded Mr. Sigal as Vice-Chair. The Task Force became a permanent subcommittee and its name was changed to that indicated in the text, but the officers remained the same until 1996 when Ms. Freeman replaced Gerald K. Smith as Chair and Mitchell Seider replaced Mr. Sheinfeld as Vice Chair. The members of the Committee are knowledgeable and interested lawyers skilled in all phases of bankruptcy cases, both large and small. A substantial number of working papers were prepared by members of the Committee over the last decade. The papers and the discussion generated thereby have contributed to the awareness of ethical issues in bankruptcy cases.

33. American Bar Association House of Delegates Res. 119A (Aug. 1991) (enacted). As indicated in the text, the initial work of the committee led to a resolution of the American Bar Association House of Delegates recommending the abandonment of the disinterestedness requirement for counsel for the debtor-in-possession.

34. Bankruptcy courts have interpreted the requirement that counsel for a trustee be disinterested and not hold or represent an interest adverse to the estate (Bankruptcy

Most of the attention of judges and practitioners has been on the disinterestedness and no adverse interest requirements of the Bankruptcy Code.³⁵ However, several bankruptcy courts have considered disqualifying conflicts under state Rules of Professional Conduct.³⁶ Nonetheless, how state

Code § 327) to apply to counsel for a debtor-in-possession (Bankruptcy Code § 1107). The definition of disinterested entails, among other things, not being a creditor, not being an officer or director of the debtor within two years of the bankruptcy petition filing date, and not having an interest materially adverse to the interest of the estate or any class of creditors or equity security holders by reason of any direct or indirect relationship to, connection with, or interest in the debtor (Bankruptcy Code § 101(14)).

Courts have divided with respect to whether the fact that an attorney in the prospective debtor-in-possession counsel's law firm holds a minor equity interest in the debtor or holds a non-management officership (such as assistant secretary), or the law firm is owed for prepetition attorneys' fees disqualifies the attorney under the disinterestedness test. This subcommittee and the ABA Business Bankruptcy Committee and ABA House of Delegates have urged Congress to amend the Bankruptcy Code to provide that counsel for a debtor-in-possession need not be disinterested, but should be judged by otherwise applicable conflict of interest rules. Apart from the issue of disinterestedness, the subcommittee proposes a specific comment to Restatement § 206 to address its applicability to a lawyer's connections to a debtor-in-possession.

The committee urges that whether a lawyer's claim for attorneys' fees or equity interest will result in a substantial risk of materially, adversely affecting the lawyer's representation depends on the size of the claim or stake in the bankruptcy case, measured from the perspective of both the debtor and the creditor law firm, and the intended treatment of the claim or equity stake, if known. Further, unless the lawyer knows of potential claims against officers, service as a non-management officer should not entail such a risk.

ABA Business Bankruptcy Law Committee, Bankruptcy Ethics Subcommittee, *Restatement of the Law, The Law Governing Lawyers, Bankruptcy Issues*, Panel Paper Presented at the American Law Institute Conference in Orlando, Florida 5-6 (1993).

35. Two additional conflict of interest rules in the Bankruptcy Code preclude an examiner from becoming a trustee, 11 U.S.C. § 321(b) (1994), or being employed by a trustee, 11 U.S.C. § 327(f) (1994). The Bankruptcy Rules regulate the procedural aspects of employment. Bankruptcy Rule 2014(a) requires an application to employ and the accompanying verified statement, to disclose as to the person to be employed all of such person's connections with the United States Trustee or any person employed in the Office of the United States Trustee. The Advisory Committee Note to Rule 2014 states that the 1991 Amendment introducing such disclosure requirement

is not intended to prohibit the employment of such persons in all cases or to enlarge the definition of "disinterested person" in [§ 101(14)] of the Code. However, the court may consider a connection with the United States trustee's office as a factor when exercising its discretion. Also, this information should be revealed in the interest of full disclosure and confidence in the bankruptcy system, especially since the United States trustee monitors and may be heard on applications for compensation and reimbursement of professionals employed under this rule.

BANKR. R. 2014(a), Advisory Committee Note (Supp. 1997). Another conflict provision is found in Bankruptcy Rule 5004 and concerns judges.

36. *E.g., In re Spivy Chevrolet, Inc.*, 30 Bankr. Ct. Dec. (CCH) 116 (Bankr. E.D. Ark. 1996)

conflict rules apply to bankruptcy cases is largely unexplored. This is especially true as to conflicts arising due to simultaneous representation. This type of conflict has been referred to by Professor Nathan M. Crystal as an "unrelated matter conflict of interest."³⁷

With one exception, treatises on ethics for lawyers do not address ethical issues in bankruptcy cases; as to the important subject of disqualification at the request of a client represented in an unrelated matter who is a party in interest in a bankruptcy case, or what will be referred to hereafter as a simultaneous representation conflict, there is no coverage.³⁸ The bankruptcy treatises also overlook simultaneous representation conflicts.³⁹ Over the last fifteen years

(trustee and principal of debtor sought to disqualify counsel for creditor on the basis of conflict of interest in a chapter 7 case).

37. Nathan M. Crystal, *Disqualification of Counsel for Unrelated Matter Conflicts of Interest*, 4 GEO. J. LEGAL ETHICS 273, 274 (1990).

This form of conflict occurs when a lawyer represents one client while that lawyer or another member of her firm is simultaneously representing that client's adversary, not directly against the first client, but in an unrelated matter. For instance, a firm may represent client A in litigation against B, while simultaneously representing B in an unrelated matter.

Id.

38. See, e.g., AMERICAN BAR ASS'N & THE BUREAU OF NAT'L AFFAIRS, INC., *LAWYER'S MANUAL ON PROFESSIONAL CONDUCT* § 51:101 (1997) (discussing simultaneous representation of adverse interest); GEOFFREY C. HAZARD & W. WILLIAM HODES, *THE LAW OF LAWYERING: A HANDBOOK ON THE MODEL RULES OF PROFESSIONAL CONDUCT* (2d ed. 1997) (no illustrative bankruptcy cases cited in the volume let alone in connection with simultaneous representation conflicts); RONALD E. MALLIN & RONALD E. SMITH, *LEGAL MALPRACTICE* §§ 19:11-15 (3d ed. 1989) (discussing "bankruptcy and debtor-creditor relationship" law, with the most detailed discussion found in the ethics treatises); NATIONAL REPORTER ON LEGAL ETHICS AND PROFESSIONAL RESPONSIBILITY (1996) (discussing state court interpretations and opinions of state bar but not discussing any bankruptcy cases); CHARLES W. WOLFRAM, *MODERN LEGAL ETHICS* § 7.3.2 (1986) (discussing simultaneous representation conflicts but not discussing or citing any bankruptcy cases).

Based on my familiarity with bankruptcy cases and secondary authorities, I had assumed there was a void. I wish to thank Christina M. Entekin, a third-year student of law at Arizona State University, for carefully reviewing the secondary materials. The results confirmed my assumption.

39. See, e.g., WILLIAM L. NORTON, JR., *BANKRUPTCY LAW AND PRACTICE* (2d ed. 1994) (discusses the representation of multiple, affiliated entities in bankruptcy cases, but does not discuss simultaneous representation conflicts); 2 COLLIER ON BANKRUPTCY § 327 (Lawrence W. King, ed., 15th ed. 1996). Chapter 327 of *Collier on Bankruptcy*, entitled "employment of professional persons," follows the provisions of § 327 of the Bankruptcy Code in discussing the employment of professionals, but its focus is on adversity of interest to the estate or disinterestedness, not simultaneous representation conflicts. However, § 327.04(5) does discuss whether concurrent representation is a per se violation of the Bankruptcy Code where the representation concurrent to that in the bankruptcy case is on an entirely unrelated matter. There is also a discussion of multi-debtor representation which focuses on large multi-debtor reorganization cases where it is commonplace for one law firm, or a group of law firms, to represent all of the debtor entities.

or so there have been a handful of law review articles discussing simultaneous representation conflicts, and a few actually discuss such conflicts in the context of bankruptcy.⁴⁰

State Rules of Professional Responsibility preclude a lawyer from suing a client represented in an unrelated matter.⁴¹ The application of this rule in federal bankruptcy cases raises two issues. The first is one of federal-state relations or preemption briefly discussed in an interesting Arizona case. In *In re Breen*,⁴² Breen represented Hubbell and negotiated a loan from Hubbell to Macy secured by real property. Macy defaulted and Hubbell foreclosed. Breen no longer represented Hubbell and did not handle the foreclosure. Shortly before the foreclosure sale, Breen filed a Chapter 11 case for Macy without obtaining Hubbell's consent or informing Hubbell of the intended action. The Disciplinary Committee had given short thrift to the defense that § 327(c) of the Bankruptcy Code preempts the state rule.⁴³ Section 327(c) provides:

40. See, e.g., Neal Batson, *Conflicts, Privileges and Sanctions in Bankruptcy Cases and Proceedings: An Outline*, in ANNUAL SURVEY OF BANKRUPTCY LAW 245 (William L. Norton, Jr., ed., 1987); Crystal, *supra* note 37; Regina S. Kelbon et al., *Conflicts, the Appointment of "Professionals," and Fiduciary Duties of Major Parties in Chapter 11*, 8 BANKR. DEV. J. 349 (1991); Robert P. Lawry, *The Meaning of Loyalty*, 19 CAP. U. L. REV. 1089 (1990); Richard Lieb, *Sections 330, 331, 503(b), 506(b)—Attorney Compensation*, in ANNUAL SURVEY OF BANKRUPTCY LAW 427, 445-50 (William L. Norton, Jr., ed., 1987); Richard Lieb, *Sections 329-331—Attorney Compensation*, in ANNUAL SURVEY OF BANKRUPTCY LAW 329, 335-338 (William L. Norton, Jr., ed., 1986); Kevin McMunigal, *Rethinking Attorney Conflict of Interest Doctrine*, 5 GEO. J. LEGAL ETHICS 823 (1992); Nancy J. Moore, *Conflicts of Interest in the Simultaneous Representation of Multiple Clients: A Proposed Solution to the Current Confusion and Controversy*, 61 TEX. L. REV. 211 (1982); Thomas D. Morgan, *Suing a Current Client*, 1 J. INST. FOR STUDY LEGAL ETHICS 87 (1996); David A. Rosenzweig, *Sections 327-331—Attorney Compensation*, in Annual Survey of Bankruptcy Law 297, 301-312, 399-409 (William L. Norton, Jr., ed., 1994-95); David A. Rosenzweig, *Sections 327-331—Attorney Compensation*, in ANNUAL SURVEY OF BANKRUPTCY LAW 377, 382-398 (William L. Norton, Jr., ed., 1990); Gerald K. Smith, *Disinterestedness*, in ANNUAL SURVEY OF BANKRUPTCY LAW 639, 855, 860-879 (William L. Norton, Jr., ed. 1995-96); R. Craig Smith, *Conflicts of Interest Under the Bankruptcy Code: A Proposal to Increase Confidence in the Bankruptcy System*, 8 GEO. J. LEGAL ETHICS 1045 (1995).

There have been several additional articles discussing ethics in the bankruptcy context. Professor Jack Ayer wrote an insightful article on the general subject. See John D. Ayer, *How to Think About Bankruptcy Ethics*, 60 AM. BANKR. L.J. 355 (1986). Mr. Kent Meyers wrote an article discussing multiple representation conflicts in the bankruptcy context. See D. Kent Meyers, *Ethical Considerations in the Representation of Multiple Creditors Against a Single Debtor*, 51 AM. BANKR. L.J. 19 (1977). Susan M. Freeman has written two articles on the subject of bankruptcy ethics. See Susan M. Freeman, *Qualification to Serve as DIP Counsel—The Recent Cases*, in ANNUAL SURVEY OF BANKRUPTCY LAW 139 (William L. Norton, Jr., ed., 1990); Susan M. Freeman, *Ethical Guidelines for Representing Debtors and Debtors-in-Possession*, in ANNUAL SURVEY OF BANKRUPTCY LAW 205 (William L. Norton, Jr., ed., 1987).

41. *Infra*, Parts II(C) and (D).

42. 830 P.2d 462 (Ariz. 1992).

43. *Id.* at 464.

[I]n a case under chapter 7, 12, or 11 of this title, a person is not disqualified for employment under this section solely because of such person's employment by or representation of a creditor, unless there is objection by another creditor or the United States trustee, in which case the court shall disapprove such employment if there is an actual conflict of interest.⁴⁴

The Committee stated that "the bankruptcy code does not release an attorney from his or her duties under the Arizona ethical regulations."⁴⁵ The Arizona Supreme Court affirmed the Disciplinary Committee's finding that the filing of the Chapter 11 was "an action directly adverse"⁴⁶ to Hubbell, and the finding that there were differing interests between Hubbell and Macy.⁴⁷ The Supreme Court finessed the preemption issue, stating that "the claim that the bankruptcy code insulated Respondent from his ethical duties is simply wrong."⁴⁸

The second issue is more subtle. It is whether the bankruptcy case as a whole is civil litigation, thereby implicating the state rule precluding a lawyer from suing one client on behalf of another.⁴⁹

It is clear that a reorganization case is different than "bilateral" civil litigation. This was pointed out in the Protective Committee Study nearly sixty years ago. The Report observed that "[t]he reorganization of corporations is primarily an exercise in corporate finance and management. Only incidentally are reorganization proceedings law suits; and they are never law suits in the ordinary sense of procedures designed to settle simple issues between individual litigants."⁵⁰

44. 11 U.S.C. § 327(c) (1994).

45. *Breen*, 830 P.2d at 464.

46. *Id.*

47. *Id.* at 465.

48. *Id.* The court relied on *In re Greater Pottstown Community Church of the Evangelical Congregational Church*, 80 B.R. 706 (Bankr. E.D. Pa. 1987).

49. *Infra*, Part II(D), Part III(D), and Part IV.

50. SECURITIES & EXCH. COMM'N, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES PART VIII 1 (1940)

The *Protective Committee Study* observed that "[t]his is equally true of proceedings under Sections 77 and 77B, and Chapter X, of the Bankruptcy Act, and of proceedings in equity receiverships." *Id.* at 1 n.1. The Report quoted from a 1934 district court opinion, *Lincoln Printing Co. v. Middle West Utilities Co.*, 6 F. Supp. 663, 682-83 (N.D. Ill. 1934), as follows:

The conduct of any equity receivership is of necessity largely administrative; it involves more than a decision of "yes" or "no" upon a single issue or a multiple of single issues presented by appropriate pleadings. It involves decisions on matters of policy with nice gradations of refined reasoning and conservative judgment . . . often . . . questions of policies or courses of conduct concerning which two apparently equally consistent views may be taken. Such questions and situations constantly recur

The Protective Committee Study also observed that “[i]t is only after these broader economic and business issues are decided that attention should properly be given to questions concerning the extent of the participations to be allocated among former security holders, the problem of the ‘fair plan’ as traditionally understood.”⁵¹

It is also true that a reorganization is largely consensual. Equity and debt securities are often altered in both form and substance. The reorganized debtor is often different than the original debtor. However, although the mechanism exists to “cramdown” a reorganization, generally speaking affected classes will consent by the requisite majority. Indeed, one of the functions of committees is to assist in obtaining the requisite consents to the plan.

But even though a reorganization case differs in important respects from bilateral, civil litigation, this is not dispositive. The question remains whether the rule precluding a lawyer from suing a client in an unrelated matter precludes a lawyer from filing a reorganization case or representing a trustee or debtor-in-possession in a reorganization case if a party in interest is a client in an unrelated matter.

The Bankruptcy Code’s adverse interest rule and state disqualification rules as to simultaneous representation are related but different—like the opposite sides of a coin. An example may make this clear. Take the common situation of counsel for a bank in matters not involving a particular debtor. Bank counsel may be asked by the debtor to file a Chapter 11 case and represent the debtor-in-possession after the case has been filed. Depending on counsel’s relationship with the bank, the representation of the bank in unrelated matters

in the conduct of an equity receivership, giving to it a character requiring the exercise of administrative jurisdiction, as distinguished from decision of controverted or litigated issues.

SECURITIES & EXCH. COMM’N, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES PART VIII 1 n.1 (1940).

The *Protective Committee Study* delineated “the most important aspects of reorganization.” *Id.* at 2.

Reorganization involves all the problems of corporate finance and management: it requires an inquiry into the causes of the financial collapse of the corporation; and into its worth if salvaged as a going concern; and, if reorganization instead of liquidation is determined upon, how this can best be accomplished upon a basis not only fair but economically sound. The answers to these questions will necessitate inquiry among other things into general economic factors, competitive conditions in the industry, its trend of demand, and its price policies, as well as inquiry into more immediate questions such as the quality of the debtor’s management. More narrowly, there will have to be inquiry into earnings in the past and the prediction of future earnings, and chiefly on the latter basis, a determination of what would constitute a sound capitalization and financial structure.

Id. at 1-2.

51. *Id.* at 2.

may constitute an adverse interest under the Bankruptcy Code which will prevent counsel from representing the debtor-in-possession.⁵² And even if counsel clears this hurdle, the other side of the coin must be considered and absent appropriate consent state rules may disqualify counsel from representing the debtor-in-possession on the basis that this would result in a conflict of interest.⁵³

Conflict rules are unclear as to their application to collective proceedings, such as a bankruptcy case or equity receivership.⁵⁴ It is also uncertain which conflict rules apply.⁵⁵ The Bankruptcy Code provisions are also difficult to apply. The disinterested standard formulated in the 1930s was to assure the independence of trustees in major reorganization cases.⁵⁶ But we now have management continued in control, and the disinterestedness standard is the wrong size shoe for counsel for management.

These uncertainties contribute to the occurrence of periodic scandals⁵⁷ which generate disrespect for the judicial system, and lead to sanctions⁵⁸ and breach of fiduciary duty claims.⁵⁹ The conflict rules of the twentieth century

52. *In re Amdura Corp.*, 121 B.R. 862 (Bankr. D. Colo. 1990). "The Court questions whether counsel can be said to be disinterested when they acknowledge their inability to take a position contrary to Continental because, at least as to W & S, it is unwilling to offend the 'hand that feeds.'" *Id.* at 867.

The question of whether F & W is "disinterested" within the meaning of section 327 of the Code is really one that only F & W can answer. In the Court's view, the firm's past representation of that bank does not create a conflict within the meaning of 327, or otherwise make F & W not disinterested, unless that law firm, for whatever reason, believes that it would not be able to diligently and zealously represent the debtors on issues concerning the Continental loan. If the Continental is not the "hand that feeds" F & W, and if the firm is not otherwise inhibited, then past representation of the Continental on matters not relating to these debtors would not serve to disqualify F & W from acting as counsel for the fiduciary in these cases.

As to W & S, the same analysis must apply. That firm, however, has openly declared its inability or, at least, unwillingness to joust with the bank. It appears to the Court, as concluded in the Order, that issues surrounding the Continental Bank are so pervasive, and the Bank's status as a multimillion-dollar-a-year client of W & S is so significant, that it is difficult, if not impossible, for this Court to reach the conclusion that W & S is "disinterested."

Id. at 871.

53. *Infra*, Part III(D) and Part IV.

54. *Infra*, Part III(D) and Part IV.

55. *Infra*, Part II(B).

56. See H.R. REP. NO. 1409, at 38 (1937).

57. E.g., Laurence Zuckerman, *Judgment Day for a Legal Powerhouse*, N.Y. TIMES, September 25, 1994, § 3, at 1.

58. *In re Bonneville Pac. Corp.*, 29 Bankr. Ct. Dec. (CCH) 99 (Bankr. D. Utah 1996); *In re Leslie Fay Co., Inc.*, 175 B.R. 525 (Bankr. S.D.N.Y. 1994); *In re Bonneville Pac. Corp.*, 147 B.R. 803 (Bankr. D. Utah 1992); *In re Kendavis Indus. Int'l, Inc.*, 91 B.R. 742 (Bankr. N.D. Tex. 1988).

59. See generally John F. Sutton, Jr., *The Lawyer's Fiduciary Liabilities to Third Parties*, 37

need to be improved. Recent developments give some cause for optimism that we can develop rules for the twenty-first century, but it is not an easy task.

In 1986, the American Law Institute took on the task of restating the Law Governing Lawyers.⁶⁰ Chapter 8 of the *Restatement of the Law Governing Lawyers* ("Restatement") concerns conflicts of interest. The *Restatement's* definition of conflict of interest is a significant improvement over existing formulations. "A conflict of interest is involved if there is a substantial risk that the lawyer's representation of the client would be materially and adversely affected by the lawyer's own interests or by the lawyer's duties to another current client, a former client, or a third person."⁶¹ But this formulation only addresses one side of the coin, like the Bankruptcy Code adverse interest standard.⁶² The other side of the coin is partially addressed by additional, specific rules.⁶³ These rules are helpful, but the Reporters intentionally eschew efforts to create separate conflict rules for bankruptcy, insolvency and other collective proceedings.

A Commission was established by Congress in October of 1994 to review the bankruptcy law.⁶⁴ It is a nine member Commission. The members were selected by the President, Chief Justice and Congressional leadership of both parties.⁶⁵ Its charter is:

- (1) to investigate and study issues and problems relating to title 11, United States Code (commonly known as the "Bankruptcy Code");
- (2) to evaluate the advisability of proposals and current arrangements with respect to such issues and problems;

S. TEX. L. REV. 1033, 1035-1042 (1996). Professor Sutton states that "[c]ourts are adamant in requiring that a lawyer's loyalty to each client be unswayed by the lawyer's self-interest or other extraneous influences." *Id.* at 1035. Sutton distinguishes between an action for malpractice and an action for breach of fiduciary duty. The malpractice claim involving violation of a standard of care while a breach of fiduciary duty involves violation of a standard of conduct. *Id.* at 1042. *See also* Damron v. Herzog, 67 F.3d 211, 213 (9th Cir. 1995) (recognizing a claim against a former lawyer who represents an adverse party in a substantially related matter).

60. Charles W. Wolfram, *The Concept of a Restatement of the Law Governing Lawyers*, 1 GEO. J. LEGAL ETHICS 195, 198-200 (1987).

61. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 201 (Proposed Final Draft No. 1, 1996).

62. *See* Moore, *supra* note 40.

63. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS §§ 209, 211, 212 (Proposed Final Draft No. 1, 1996).

64. Section 602 of the Bankruptcy Reform Act of 1994.

65. Its members are Brady C. Williamson, Esq. (Chairman), Hon. Robert E. Ginsberg (Vice-Chairman), Jay Alix, M. Caldwell Butler, Jr., Esq., M. Babette A. Ceccotti, Esq., John A. Gose, Esq., Jeffrey J. Hartley, Esq., Hon. Edith Hollan Jones and James I. Shepard, Esq. Its Reporter is Professor Elizabeth Warren. Professor Lawrence P. King and Stephen H. Case, Esq. are Advisors. Its staff includes Elizabeth I. Holland, Esq., Melissa Jacoby, Esq. and George Singer, Esq.

(3) to prepare and submit to the Congress, the Chief Justice, and the President a report in accordance with section 608; and

(4) to solicit divergent views of all parties concerned with the operation of the bankruptcy system.⁶⁶

The Commission established a Working Group on Service and Ethics. The Working Group was asked to make recommendations as far as standards for employment of professionals, a national rule governing the admission to practice in bankruptcy courts and multiple party representation.⁶⁷

Another development was triggered by the controversial Reno Regulations⁶⁸ and the uncertainty as to the ethical rules applicable in federal cases. The Committee on Rules of Practice and Procedure of the Judicial Conference of the United States ("Standing Committee") directed its Reporter, Professor Daniel R. Coquillette, of Boston College Law School, to review federal local rules governing attorney conduct. Professor Coquillette's Report describes the sensitive nature of the project and the magnitude of the problem:

No area of local rulemaking has been more fragmented than local rules governing attorney conduct. This difficult subject was first raised at the outset of the Local Rules Project in 1988, and was then discussed extensively by the Standing Committee at a Special Conference on Local Rules, convened by the Committee at Boston College on November 14, 1988. Many of the goals of the Local Rules Project, including uniform numbering, were relatively uncontroversial, but review of local rules governing attorney conduct proved to be highly contentious. Rather than

66. Section 603 of the Bankruptcy Reform Act of 1994.

67. The Working Group is under the guidance of Commission Advisor Professor Lawrence P. King who is ably assisted by Staff Attorney Elizabeth I. Holland. The Group includes Commissioners M. Caldwell Butler, Esq. and Hon. Robert E. Ginsberg, and Participants, Donald S. Bernstein, Michael A. Bloom, Bernard Shapiro, Gerald K. Smith and Professor Charles P. Wolfram.

68. The states, through their bar associations, have long had primary responsibility for regulating the ethical conduct of lawyers. Despite the history of state control over ethical standards, on August 4, 1994, the Department of Justice (Department), under Attorney General Janet Reno, adopted a regulation known as the "Reno Rule." The Reno Rule purports to exempt federal prosecutors from the "no-contact" rules of the states in which they are licensed to practice law.

Todd S. Schulman, *Wisdom Without Power: The Department of Justice's Attempt to Exempt Federal Prosecutors From State No-Contact Rules*, 71 N.Y.U. L. REV. 1067 (1996). Mr. Schulman asserts that inconsistent interpretations of the no-contact rule by state courts and state disciplinary bodies has resulted in uncertainty which has had an adverse impact on the performance of federal prosecutors. *Id.* The author makes a persuasive argument in support of federal preemption.

jeopardize the early progress of the Local Rules Project, it was decided to defer this divisive issue to a later date.

Since that time, the “balkanization” of local rules governing attorney conduct appears to have grown worse [T]here are now seven fundamentally different approaches, and even within these “groups” there are great variations. The most common approach, local rules that incorporate the relevant standards of the state in which the district is located, actually divides federal districts because of the many differing state rules. . . . The Department of Justice, other major federal agencies, and many national legal organizations, including civil rights groups, national corporations, financial networks, large law firms, and groups facing multi-district litigation have been severely inconvenienced. . . . Further, the rise of legal malpractice actions has led to subsidiary dispute about choice of law—often of mind numbing complexity. This situation has led some major governmental agencies, including the Department of Justice, to consider adopting their own professional standards. The Department of Justice has now actually done so with regard to communications with represented parties, promulgating new Department regulations that differ significantly from most state standards and the standards adopted by local rule in most Districts and Circuits. . . . This adds further to the number and variation of the rules.⁶⁹

After considering the Report, the Standing Committee voted to hold a special study conference and the Chair of the Standing Committee, Honorable Alice-Marie Stotler, directed Professor Coquillette to determine the frequency with which ethical issues arise in reported federal cases. This led to an additional report to the Standing Committee.⁷⁰

The Special Study Group considered the two Reports at two sessions—one in January, 1996 in California and one in June, 1996 in Washington, D.C. At the conclusion of the second session, a substantial majority of the Study Group favored the drafting of a model local rule, but did not favor a uniform rule promulgated under the Rules Enabling Act. A majority concluded that additional empirical data should be gathered as to (1) the experience in districts that had adopted the earlier model rule, (2) the experience in districts that handle attorney discipline matters, (3) the experience with attorney discipline in the courts of appeal, and (4) the federal decisional law involving discipline of attorneys.⁷¹

Yet another development was the creation of a Disclosure Subcommittee in 1995, by Bankruptcy Judge Paul Mannes, then Chairman of the Advisory

69. DANIEL R. COQUILLETTE, REPORT ON LOCAL RULES REGULATING ATTORNEY CONDUCT 1-2 (July 5, 1995) [hereinafter COQUILLETTE REPORT].

70. DANIEL R. COQUILLETTE, STUDY OF RECENT FEDERAL CASES (1990-1995) INVOLVING RULES OF ATTORNEY CONDUCT (December 1, 1995) [hereinafter COQUILLETTE STUDY].

71. Judicial Conference of the United States, Standing Committee, June 1996 Minutes.

Committee on Bankruptcy Rules. Its purpose is to review and make recommendations as to the rules regulating employment of professionals and disclosures. While the Rules Committee may have a limited charter, it surely is empowered to promulgate rules affecting the practice before the Bankruptcy Courts, including procedural aspects of employment, required disclosures and conflict checks, admission to practice before the bankruptcy courts and applicable rules of professional conduct.⁷²

This article explores conflicts in workouts and reorganization cases. Common situations are analyzed under the conflict rules of the Bankruptcy Code, ABA rules applicable in most bankruptcy courts and the current drafts of the *Restatement*. This article also chronicles recent developments and concludes with several recommendations.

II. CONFLICT RULES FOR THE TWENTIETH CENTURY.

Conflict rules are essential for a variety of reasons, including the assurance of adequate representation, preservation of confidences and maintaining the integrity of our adversary system.⁷³ Conflict rules also preserve the intangible

72. For example, it might consider promulgating a rule that regulates bankruptcy courts. A rule might be considered that admission to practice in one bankruptcy court, usually by virtue of being admitted to practice in the relevant United States District Court, entitles an attorney, on presentation of a certificate of admission and good standing in a bankruptcy court, to appear in any other bankruptcy court in the United States. More importantly, the Committee should address the conflict rules and necessary disclosures. The Office of the U.S. Trustee is another possible source of reform. It has not yet stepped into the fray other than to police disclosures and conflicts in specific cases as required by 28 U.S.C. § 586(a)(3)(H). This is useful, but less effective than guidelines.

See Letter from Jerry Patchan, Director of the Executive Office for United States Trustees to Mr. Bradley C. Williamson, Chairman of the National Bankruptcy Review Commission (May 14, 1997) (on file with author). "Our activity in this area, reflected in a number of significant decisions, has contributed to a much stronger awareness of ethical considerations, including conflict of interest issues, among the bankruptcy bench and bar." *Id.* at 1. If the U.S. Trustee has the power to promulgate guidelines regulating private trustees, surely it has the power to do so as to professionals employed in bankruptcy cases.

73. The prohibition against lawyer conflicts of interest reflects several competing concerns. . . .

....

Second, the prohibition against conflicts of interest seeks to enhance the effectiveness of legal representation. To the extent that a conflict of interest undermines the independence of the lawyer's professional judgment or inhibits a lawyer from working with appropriate vigor in the client's behalf, the client's expectation of effective representation (see § 28) could be compromised.

Third, a client has a legal right to have a lawyer safeguard the client's confidential information (see § 112). Preventing use of confidential client information against the interests of the client, either to benefit the lawyer's personal interest, in aid of some other client, or to foster an assumed public purpose is facilitated through

bond between client and lawyer.⁷⁴ Call it loyalty, call it what you will, we perhaps sense it better than we define it. Our reaction to specific situations is the true litmus test. Perhaps it is our sense of injustice that is involved. The Twentieth Century Codes do not adequately codify this bond, loyalty or sense of injustice.

But there is a downside as well. Conflict rules limit the client's choice of counsel, often at a substantial cost. They also affect lawyers as far as choice of clients and matters that can be handled.

On the other hand, avoiding conflicts of interest can impose significant costs on lawyers and clients. Prohibition of conflicts of interest should therefore be no broader than necessary. First, conflict avoidance can make representation more expensive. To the extent that conflict of interest rules prevent multiple clients from being represented by a single lawyer, one or both clients will be required to find other lawyers. That might entail uncertainty concerning the successor lawyers' qualifications, usually additional cost, and the inconvenience of separate representation. In matters in which individual claims are small, representation of multiple claimants might be required if the claims are effectively to be considered at all. Second, limitations imposed by conflicts rules can interfere with client expectations. At the very least, one of the clients might be deprived of the services of a lawyer whom the client had a particular reason to retain, perhaps on the basis of a long-time association with the lawyer. In some communities or fields of practice there might be no lawyer who is perfectly conflict-free. Third, obtaining informed consent to conflicted representation itself might compromise important interests. As discussed in § 202, consent

conflicts rules that reduce the opportunity for such abuse. . . .

....

Finally, some conflict of interest rules protect interests of the legal system in obtaining adequate presentations to tribunals. In the absence of such rules, for example, a lawyer might appear on both sides of the litigation, complicating the process of taking proof and compromising adversary argumentation (see § 209).

RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 201 cmt. b (Proposed Final Draft No. 1, 1996).

74. The prohibition against lawyer conflicts of interest reflects several competing concerns. First, the law seeks to assure clients that their lawyers will represent them with undivided loyalty. A client is entitled to be represented by a lawyer whom the client can trust. Instilling such confidence is an objective important in itself. For example, the principle underlying the prohibition against a lawyer's filing suit against a present client in an unrelated matter (see § 209, Comment *e*) may also extend to situations, not involving litigation, in which significant impairment of a client's expectation of the lawyer's loyalty would be similarly likely. Contentious dealings, for example involving charges of bad faith against the client whom the lawyer represents in another matter would raise such a concern. So also would negotiating on behalf of one client when a large proportion of the lawyer's other client's net worth is at risk.

Id.

to a conflict of interest requires that each affected client give consent based on adequate information. The process of obtaining informed consent is not only potentially time-consuming; it might also be impractical because it would require the disclosure of information that the clients would prefer not to have disclosed, for example, the subject matter about which they have consulted the lawyer. Fourth, conflicts prohibitions interfere with lawyers' own freedom to practice according to their own best judgment of appropriate professional behavior. It is appropriate to give significant weight to the freedom and professionalism of lawyers in the formulation of legal rules governing conflicts.⁷⁵

A. *Bankruptcy Code Conflict Rules.*

The Bankruptcy Code has several provisions regulating the employment of professionals.⁷⁶ The primary rules are that a trustee cannot employ a professional who represents or holds an interest adverse to the estate or is not disinterested,⁷⁷ with a modest exception.⁷⁸ While the phrase "interest adverse to the estate" is not defined, disinterested person is defined as a person who "does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor or [certain investment bankers];" "is not a creditor, an equity security holder, or an insider;" "is not and was not, within two years before the date of the filing of the petition a director, officer, or employee of the debtor or of [certain investment bankers];" "is not and was not an investment banker for any outstanding security of the debtor," and was not within three years of the petition "an investment banker for a security of the debtor, or an attorney for such an investment banker in connection with the offer, sale, or issuance of a security of the debtor."⁷⁹ From a conflict standpoint, the most controversial

75. *Id.*

76. 11 U.S.C. § 327(a), (c), (e) and (f). *Cf.* 11 U.S.C. § 328(c).

77. 11 U.S.C. § 327(a). *Cf.* 11 U.S.C. § 328(c).

78. 11 U.S.C. § 327(e).

79. 11 U.S.C. § 101(14). "[D]isinterested person" means person that —

(A) is not a creditor, an equity security holder, or an insider;

(B) is not and was not an investment banker for any outstanding security of the debtor;

(C) has not been, within three years before the date of the filing of the petition, an investment banker for a security of the debtor, or an attorney for such an investment banker in connection with the offer, sale, or issuance of a security of the debtor;

(D) is not and was not, within two years before the date of the filing of the petition, a director, officer, or employee of the debtor or of an investment banker specified in subparagraph (B) or (C) of this paragraph; and

aspect of the "disinterestedness test" is its frequent disqualification of counsel for a debtor after the filing of a Chapter 11 case. This often results from the requirement that the professional not be a creditor, equity security holder, insider, or officer, director, or employee of the debtor within two years of the petition, but almost invariably the court finds an actual conflict of interest.⁸⁰

The only provision of the Bankruptcy Code expressly touching on the employment of professionals by a debtor-in-possession provides that a professional is not disqualified from representing a debtor-in-possession simply because of prebankruptcy employment by or representation of the debtor.⁸¹ Despite the fact that the reorganization chapters of the Bankruptcy Act of 1898 did not require that counsel for the debtor-in-possession be disinterested, bankruptcy courts have generally imposed such a requirement under the Bankruptcy Code.⁸² However, courts are reluctant to apply the

(E) does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor or an investment banker specified in subparagraph (B) or (C) of this paragraph, or for any other reason.

Id. To fully grasp the prohibited relationships, it is necessary to consider additional definitions in the Bankruptcy Code including § 101(2) ("affiliate"), § 101(9) ("corporation"), § 101(31) ("insider"), § 101(45) ("relative"), § 101(49) ("security"), § 101(10) ("creditor"), § 101(17) ("equity security holder"); and § 101(41) ("person").

80. 11 U.S.C. § 101(14)(A) and (D).

81. 11 U.S.C. § 1107(b) ("Notwithstanding section 327(a) of this title, a person is not disqualified for employment under section 327 of this title by a debtor in possession solely because of such person's employment by or representation of the debtor before the commencement of the case.")

82. See *In re Best W. Heritage Inn Partnership*, 79 B.R. 736 (Bankr. E.D. Tenn. 1987); see also Gerald K. Smith, *Disinterestedness*, in ANNUAL SURVEY OF BANKRUPTCY LAW 639 (William L. Norton, Jr., ed., 1995-96).

Nowhere in the Code or the legislative history is it expressly provided that counsel for a debtor in possession must be disinterested. But somewhere along the way a drafting problem arose. The Senate staff added to the section dealing with the rights, powers and duties of a debtor in possession subparagraph (b), innocuous in and of itself, which provided that "[n]otwithstanding section 327(a) of this title, a person is not disqualified for employment under section 327 of this title by a debtor in possession solely because of such person's employment by or representation of the debtor before the commencement of the case."

In the final debates on the legislation, the Senate staff prevailed as to the new provision and there was also inserted "a technical amendment contained in the Senate amendment indicating that an attorney for the debtor in possession is not disqualified for compensation for services and reimbursement of expenses simply because of prior representation of the debtor." This was accomplished by inserting a cross reference in § 328(c) to § 1107(b). The Joint Legislative Statement did not state or even imply that counsel for the debtor in possession must be disinterested. Nor did the Joint Legislative Statement discuss the reason for the inclusion from the Senate Bill of what became § 1107(b), which provided that a person was not disqualified to represent a debtor in possession "solely because of such person's employment, by or

disinterestedness standard literally. The most common problem is that proposed counsel for the debtor has a prepetition claim for services leading up to the filing. Courts generally ignore this problem on the basis that the need for court approval of the fees avoids prepetition creditor status.⁸³ This is

representation of the debtor before the commencement of the case.”

Until the inclusion of the provision from the Senate Bill, there was no possible inference that counsel for the debtor in possession must be disinterested. It can be inferred, however, from § 1107(b) that Congress intended to bring the employment of counsel for the debtor in possession under § 327. Nonetheless, in light of the prior practice, a more plausible interpretation is that the amendments were intended to negate the possibility that prefilings counsel for the debtor might be considered to have a materially adverse interest and thus be disqualified from acting as counsel for the debtor in possession. But as a result of the draftsmen carving out one exception, it can be inferred that the disinterestedness requirement otherwise applies. Such interpretation ignores the status of the law prior to October 1, 1979, the effective date of the Bankruptcy Code, and the absence of any express statutory provision overruling the prior law. There is also a lack of any legislative history suggesting a disinterestedness requirement for counsel for the debtor in possession. Surely such a dramatic change would not have been done in such a delicate way. It would have been controversial and widely discussed. A canon of construction often invoked by the Supreme Court of the United States is that the rules that were established under the Bankruptcy Act continue unless explicitly repealed or modified. That is not the situation as to § 1107(b). Even the legislative history is silent. Nonetheless, the Bankruptcy Bench assumes that counsel for a debtor in possession must be disinterested.

Id. at 642-44 (footnotes omitted).

83. See, e.g., *In re Martin*, 817 F.2d 175 (1st Cir. 1987). In *In re Martin*, a husband and wife consulted counsel as to their precarious financial straits because of a failing restaurant business; the outcome was the filing of a Chapter 11. Prior to filing the Chapter 11, by way of retainer, counsel received in addition to \$500 cash, a note in the amount of \$100,000 secured by improved real property “which the debtors did not intend to liquidate in the anticipated course of the Chapter 11 reorganization.” *Id.* at 176. The bankruptcy court “found that the Mortgage constituted an interest adverse to the bankrupts’ estate.” *Id.* at 177 (citing *In re Martin*, 59 B.R. 140, 143 (Bankr. D. Me. 1986), *aff’d*, 62 B.R. 943 (D. Me. 1986), *vacated and remanded*, 817 F.2d 175 (1st Cir. 1987)). The district court affirmed the bankruptcy court’s finding. *In re Martin*, 62 B.R. 943 (D. Me. 1986), *vacated and remanded*, 817 F.2d 175 (1st Cir. 1987).

We turn, then, to a fuller consideration of § 327(a). At first blush, this statute would seem to foreclose the employment of an attorney who is in any respect a “creditor.” But, such a literalistic reading defies common sense and must be discarded as grossly overbroad. After all, any attorney who may be retained or appointed to render professional services to a debtor in possession becomes a creditor of the estate just as soon as any compensable time is spent on account. Thus, to interpret the law in such an inelastic way would virtually eliminate any possibility of legal assistance for a debtor in possession, except under a cash-and-carry arrangement or on a *pro bono* basis. It stands to reason that the statutory mosaic must, at the least, be read to exclude as a “creditor” a lawyer, not previously owed back fees or other indebtedness, who is authorized by the court to represent a debtor in connection with reorganization proceedings—notwithstanding that the lawyer will almost instantaneously become a creditor of the estate with regard to the charges endemic to current and future

nothing but a valiant attempt to make serviceable a flawed rule. Other courts avoid disqualification if the professional waives the prepetition claim.⁸⁴

More radical are cases where the courts have avoided disqualification by refusing to impute to the law firm the status of one member of the firm, e.g., status as a director.⁸⁵ Judge Norris on behalf of a panel of the Sixth Circuit

representation.

Martin, 817 F.2d at 180 (footnotes and citations omitted).

84. *See, e.g.*, *United States Trustee v. PHM Credit Corp.* (*In re PHM Credit Corp.*), 110 B.R. 284 (E.D. Mich. 1990) (court required law firm partner to resign as secretary of corporate debtor's parent corporation as a condition to allowing representation by disinterested attorney); *In re Water Vliet Paper Co., Inc.*, 111 B.R. 131 (W.D. Mich. 1989) (court required waiver of prepetition claim as a condition to finding counsel disinterested). *But see* *United States Trustee v. Price Waterhouse*, 19 F.3d 138 (3d Cir. 1994) (waiver of \$875,000 prepetition claim did not leave accounting firm disinterested).

85. *See, e.g.*, *Vergos v. Timber Creek, Inc.*, 200 B.R. 624 (Bankr. W.D. Tenn. 1996); *Capen Wholesale, Inc. v. Michel* (*In re Capen Wholesale, Inc.*), 184 B.R. 547 (Bankr. N.D. Ill. 1995); *In re Creative Restaurant Management, Inc.*, 139 B.R. 902 (Bankr. W.D. Mo. 1992). This assumes that there is no involvement in the representation by the personally disqualified lawyer, although a technical screening is not required. In *In re Creative Restaurant Management, Inc.*, Bankruptcy Judge Arthur Federman held that the Bankruptcy Code did not disqualify a firm even if a member of the firm was ineligible to represent a Chapter 11 debtor-in-possession. "Based on the plain language of the applicable statutes, I find that there is no *per se* rule. Instead, the Bankruptcy Court must determine whether such firm has an interest which is materially adverse to the estate." *Id.* at 903. A member of the firm representing the debtors, both prepetition and postpetition in the Chapter 11 case, was an assistant secretary of one of the debtors. *Id.* at 904. The application to employ counsel pointed out that the partner had acted as an assistant secretary of one of the debtors during a period within two years of the filing of the bankruptcy petitions. *Id.* at 907. There was an additional problem. Prior to the filing of the Chapter 11 cases there was a dispute as to advice the law firm gave concerning sales taxes. The debtors claimed a loss of \$50,000 due to improper advice. *Id.* at 905. This was settled by the law firm agreeing to pay the loss if the debtors continued the employment of the law firm. The law firm agreed to deposit \$50,000 in a trust account to be paid to creditors at such time as a distribution was made to them in the anticipated bankruptcy cases. The outstanding fees were paid in full immediately prior to the filing of the bankruptcy cases. *Id.* at 906.

The United States Trustee objected to employment of the firm on two grounds: (1) that one of the partners was not disinterested because of his prior service as an officer within two years of bankruptcy and (2) the prefiling settlement of fees had the appearance of a lack of disinterestedness or a conflict of interest. Judge Federman allowed the firm to continue representing the debtor-in-possession under two conditions: (1) no member of the firm who had served as an officer or director within two years prior to filing could perform any services in the case on behalf of the debtor and (2) there would be an investigation of the prepetition fee settlement payment. *Id.* at 908. The United States Trustee filed a motion for reconsideration. Before the hearing on the motion the law firm advised its clients that even if ineligible to act as general counsel, it could be retained as special counsel. *Id.* at 909.

In this district, as Smith Gill was aware, the U.S. Trustee will withdraw its objection to retention of counsel if such counsel—as its client—instead agree that counsel will serve as special counsel to carry out duties as to which it has developed specialized knowledge. The result is that the debtor then pays two law firms to do work which could have been done more efficiently by one. In this case, the debtors declined that

nearly 10 years ago held that screening was an appropriate device to overcome the presumption that confidences in possession of an attorney will be shared with other members of the firm. In *Manning v. Waring, Cox, James, Sklar & Allen*⁸⁶ Judge Norris recognized that much has changed in the relationship between lawyer and client.

option, and instead insisted that Smith Gill continue its representation as general counsel, so long as this Court allowed it to do so.

Id.

In deciding whether the law firm should represent the Chapter 11 debtor, Judge Federman applied a two-step analysis. "First, the law firm must determine whether it has a conflict of interest under applicable ethical rules governing the conduct of attorneys. Then, the Court must determine whether the Bankruptcy Code makes such firm ineligible due, for example, to its prior relationship to the debtor." *Id.*

After reviewing the provisions of the Bankruptcy Code, Judge Federman concluded that a law firm is not ineligible just because one of its members acted as assistant secretary within two years of the petition. The United States Trustee had relied on "a number of cases in which ineligibility was imputed to a firm based on the ABA Code of Professional Responsibility." *Id.* at 911. Judge Federman pointed out that such Code no longer applied, and instead, the Model Rules governed the conduct of lawyers before the federal courts in the District of Missouri noting that:

While lawyers should of course strive to avoid even a hint of impropriety, the issue as to disqualification is no longer whether a law firm "appears" to have a conflict of interest. Instead, a firm should only be removed if it is in fact not qualified to serve. Such disqualification must be based on proven conflicts of interest, not supposition. Otherwise, the interests of a client in retaining counsel of its own choice are to be respected.

Id. at 912.

Judge Federman pointed out that Rule 1.10 imputes disqualification, not on the basis of an appearance of impropriety, but on the basis that the client's confidentiality might be compromised or members of the firm represent positions adverse to a client. *Id.* at 912. Judge Federman found that neither basis of Rule 1.10 applied, *id.*, and that there was no disqualification of the firm under § 327 of the Bankruptcy Code. Judge Federman found support for his conclusion in the United States Supreme Court's interpretation of Rule 11 of the Federal Rules of Civil Procedure which imposes sanctions on the person who signs the pleading in question. The Supreme Court held this rule applied to the attorney signing and not to the firm. Judge Federman also discussed the differing treatment of disqualification under Bankruptcy Rules 5002(a) and 5002(b). The former made it clear that the firm was disqualified as well as the individual, while the latter only prohibited the employment of the individual. *Id.* at 913.

In analyzing whether there was a material adverse interest because of the payment of fees immediately prior to the filing of the Chapter 11 case, Judge Federman concluded that this very situation was contemplated by Bankruptcy Code § 329 and Bankruptcy Rule 2017. Judge Federman observed that the United States Trustee routinely objected not only to employment of attorneys who had unpaid fees at the date of filing, but also, as in this case, to employment of attorneys whose fees had been paid. Judge Federman believed the Trustee's position to be contrary to Bankruptcy Code § 1107(b) which allows the debtor to retain its prior counsel and to Bankruptcy Code § 329 which gives the court the power to review fees. *Id.* at 916.

86. 849 F.2d 222 (6th Cir. 1988).

Perhaps these motions have become more numerous simply because the changing nature of the manner in which legal services are delivered may present a greater number of potential conflicts. Certainly, the advent of law firms employing hundreds of lawyers engaging in a plethora of specialties contrasts starkly with the former preponderance of single practitioners and small firms engaging in only a few practice specialties. In addition, lawyers seem to be moving more freely from one association to another, and law firm mergers have become commonplace. At the same time that the potential for conflicts of interest has increased as the result of these phenomena, the availability of competent legal specialists has been concentrated under fewer roofs.

Consequently, these new realities must be at the core of the balancing of interests necessarily undertaken when courts consider motions for vicarious disqualification of counsel.⁸⁷

After discussing Model Rule 1.11 and screening in the instance of lawyers who leave government service to enter private practice, Judge Norris stated that:

In view of the changing nature of the availability of legal services which we have noted above, we see no reason why the considerations which led the American Bar Association to approve appropriate screening for former government attorneys, should not apply in the case of private attorneys who change their association.⁸⁸

Recent bankruptcy court holdings have applied reasoning similar to that of Judge Norris to avoid disqualifying proposed counsel for a debtor-in-possession. These cases are interesting both from the perspective of the disinterestedness test and their application of state ethical rules. The courts in *Capen Wholesale, Inc. v. Michel (In re Capen Wholesale, Inc.)*⁸⁹ and *Vergos v. Timber Creek, Inc.*⁹⁰ concluded that neither the Bankruptcy Code nor the local state ethics rules required imputed disqualification. In *Capen* the Illinois Rules of Professional Conduct were involved. The court found that Rule 1.10(a), which governed imputed disqualification, did so only where the lawyer associated with the firm "would be prohibited from doing so by Rules 1.7, 1.8(c) or 1.9."⁹¹ Because these rules involved conflicts, the court found that the Illinois rule did not require disqualification of the disqualified member's firm. The court observed that "Congress could easily have provided for imputed disqualification if it had intended for it, having specifically done so

87. *Id.* at 224-25.

88. *Id.* at 226.

89. 184 B.R. at 547.

90. 200 B.R. at 624.

91. *Capen Wholesale*, 184 B.R. at 551 (quoting *Ill. Rules of Professional Conduct* Rule 1.10(a)).

in Bankruptcy Rule 5002(a).⁹² Both *Timber Creek* and *Capen* relied on *In re Creative Restaurant Management, Inc.*⁹³ In each of these cases, *Creative Restaurant*, *Capen Wholesale* and *Timber Creek*, some sort of screening was required.⁹⁴

These cases are contrary to the generally accepted rule: If one member of a firm has a financial or other personal interest that would materially and adversely affect the representation, such lawyer is precluded from representing the client and the conflict is imputed to the firm. They also expand the use of

92. *Id.* Bankruptcy Rule 5002(a) reads as follows:

The appointment of an individual as a trustee or examiner pursuant to § 1104 of the Code shall not be approved by the court if the individual is a relative of the bankruptcy judge approving the appointment or the United States trustee in the region in which the case is pending. The employment of an individual as an attorney, accountant, appraiser, auctioneer, or other professional person pursuant to §§ 327, 1103, or 1114 shall not be approved by the court if the individual is a relative of the bankruptcy judge approving the employment. The employment of an individual as attorney, accountant, appraiser, auctioneer, or other professional person pursuant to §§ 327, 1103, or 1114 may be approved by the court if the individual is a relative of the United States trustee in the region in which the case is pending, unless the court finds that the relationship with the United States trustee renders the employment improper under the circumstances of the case. Whenever under this subdivision an individual may not be approved for appointment or employment, the individual's firm, partnership, corporation, or any other form of business association or relationship, and all members, associations and professional employees thereof also may not be approved for appointment or employment.

BANKR. R. 5002(a). Of course, Congress did not enact Rule 5002(a) in the normal sense. It did so only indirectly by not exercising its power to reject the rule.

93. See *Timber Creek*, 200 B.R. at 627 (citing *In re Creative Restaurant Management, Inc.*, 139 B.R. 902 (Bankr. W.D. Mo. 1992)); *Capen Wholesale*, 184 B.R. at 551 (citing *Creative Restaurant*, 139 B.R. 902).

94. See *Timber Creek*, 200 B.R. at 630; *Capen Wholesale*, 184 B.R. at 551; *Creative Restaurant*, 139 B.R. at 908.

While the court concludes that screening devices may be employed to guard against any infiltration of Robinson's personal interests into the firm itself, the adequacy of those devices must be separately evaluated. As noted, this evaluation must be conducted on a case-by-case basis. Although there are many factors that may be considered, the Tennessee Formal Ethics Opinion previously discussed lists three minimum requirements for effective screening, including prohibiting discussion of sensitive matters, limiting the circulation of sensitive documents, and restricting access to files. Formal Ethics Op. 89-F-118 (Mar. 10, 1989), reprinted in *Tennessee Ethics Handbook* 171. In the present case, Robinson has agreed to resign from his respective corporate positions with the debtor and has further agreed to refrain from attending any meetings of the debtor or in any way participating in these affairs. Additionally, the bankruptcy court specifically reserved the right to monitor all related professional fees. Relying upon these measures, the Bankruptcy Court was persuaded that the debtor and Glankler Brown had erected an appropriate "Chinese Wall." The court affirms.

Timber Creek, 200 B.R. at 630 (footnotes omitted).

screening beyond its normal role of preserving confidential information through the device of a screen.

Bankruptcy courts vary as to what is an adverse interest. Since the Bankruptcy Code gives little guidance,⁹⁵ courts often look to the ABA promulgated rules of professional responsibility. This has added uncertainty in those instances where the court looked to the Model Code with its “appearance of impropriety” standard and concept of a “potential” conflict. For example, Bankruptcy Judge John Schwartz recently defined “interest adverse to the estate” as “any economic interest that would tend to lessen the value of the bankruptcy estate or that could create an actual or potential dispute.”⁹⁶

A leading bankruptcy treatise refers to adverse interest as a “catch-all clause”⁹⁷ which “appears broad enough to include anyone who in the slightest degree might have some interest or relationship that would color the independent and impartial attitude required by the Code.”⁹⁸ The writer somewhat softens the absolute language by adding “professional persons employed by the trustee should be free of any conflicting interest which might in the view of the trustee or the bankruptcy court affect the performance of their services or which might impair the high degree of impartiality and detached judgment expected.”⁹⁹

A more reasonable approach is that of the Third Circuit in *In re BH & P Inc.*,¹⁰⁰ which considered what test should be applied in determining whether a single trustee and his counsel could represent a corporation and its two principals in three related Chapter 7 cases.¹⁰¹ The trustee filed claims on behalf of the corporation in the individual stockholders’ cases and also filed complaints objecting to the dischargeability of these claims in the individual

95. See, e.g., 11 U.S.C. § 327(a) (“interest adverse to the estate”); 11 U.S.C. § 327(c) (simultaneous representation of trustee and creditor does not disqualify professional unless objection by a creditor or the U.S. Trustee and “an actual conflict of interest”); 11 U.S.C. § 327(e) (“not represent or hold any interest adverse to the debtor or to the estate with respect to the matter on which such attorney is to be employed”); 11 U.S.C. § 101(14)(E) (“interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor or an investment banker [for the debtor] or for any other reason”); 11 U.S.C. § 328(c) (“represents or holds an interest adverse to the interest of the estate with respect to the matter on which such professional person is employed”); 11 U.S.C. § 1103(b) (“attorney or accountant employed to represent a committee . . . may not, while employed by such committee, represent any other entity having an adverse interest in connection with the case”); § 1107(b) (“person is not disqualified for employment . . . by a debtor in possession solely because of such person’s employment by or representation of the debtor [prepetition]”).

96. *In re Am. Printers & Lithographers, Inc.*, 148 B.R. 862 (Bankr. N.D. Ill. 1992).

97. 2 COLLIER ON BANKRUPTCY ¶ 327.03, at 327-48 (Lawrence P. King ed., 15th ed. 1996).

98. *Id.*

99. *Id.* ¶ 327.03, at 327-33.

100. 949 F.2d 1300 (3rd Cir. 1991).

101. *Id.* at 1302.

cases.¹⁰² The trustee and his counsel filed interim applications for fees in the corporate case. A secured lender of the corporate debtor objected on the basis that the trustee and his counsel “were guilty of a conflict of interest.”¹⁰³ One of the bankruptcy court’s grounds of disqualification was that the trustee had to pursue claims of the corporation against the individuals and absent a full payment of all creditors, doing so was materially adverse to the other unsecured creditors.¹⁰⁴

The Third Circuit disagreed, finding that Section 101(14)(E) mandated disqualification based on personal status, not because of a representative capacity.¹⁰⁵ The Third Circuit considered the advantages of joint administration and the use of a single trustee and declined to mandate disqualification of the trustee in every instance of interdebtor claims.¹⁰⁶ The Third Circuit, with considerable reliance on the First Circuit’s decision in *In re Martin*,¹⁰⁷ concluded that it was up to the Bankruptcy Court to determine whether the arrangement carried with it a sufficient threat of material adversity to justify disqualification.¹⁰⁸ Finding no error in the district court’s affirmance of the bankruptcy court’s finding of material adversity, the Third Circuit affirmed.¹⁰⁹ As far as the attorneys for the trustee, the Third Circuit concluded that the 1984 amendment to Section 327(c) of the Code eliminated any per se disqualification based on the representation of a creditor; rather, the 1984 amendment focused on whether there was an actual conflict of interest.¹¹⁰ The Bankruptcy Court found an actual conflict because there were assets in the individual estates and because representation of the corporate trustee in seeking to establish its claims was necessarily in conflict with the interests of creditors in the individual cases.¹¹¹ The Third Circuit affirmed this finding.¹¹²

Other than the per se disqualification provisions of the disinterestedness test, there is little guidance in the Bankruptcy Code as to adverse interests. The definition of disinterestedness determines adverse interest from the perspective of the interests of creditors and equity security holders as well as the “estate,”¹¹³ while § 327(e) of the Bankruptcy Code requires that a professional employed for a special purpose not represent or hold any interest

102. *Id.* at 1303-04.

103. *Id.* at 1304.

104. *Id.* at 1309.

105. *Id.*

106. *Id.* at 1310-11.

107. 817 F.2d 175 (1st Cir. 1987).

108. *BH & P*, 949 F.2d at 1313.

109. *Id.* at 1313-14.

110. *Id.* at 1314.

111. *Id.* at 1315.

112. *Id.* at 1317.

113. 11 U.S.C. § 101(14).

adverse to the debtor or to the estate with respect to the matter on which the attorney is employed.¹¹⁴

What does it mean that a professional cannot represent an interest adverse to the estate? The concept of an estate has little meaning under the Bankruptcy Code. Since the employment provisions concern employment by a trustee, creditors committee and debtor-in-possession, do professionals really represent an estate? It is true that § 541(a) states that the commencement of a case creates an estate and that the estate is, comprised of property of the debtor.¹¹⁵ However, with the exception of the title of § 542, the term estate is seldom used in the Code.¹¹⁶

There have been attempts to define adverse interest or conflict of interest by the ABA and the courts, but the most instructive formulation is that of the *Restatement*. Section 201 defines a conflict of interest as "a substantial risk that the lawyer's representation of the client would be materially and adversely affected by the lawyer's own interests or by the lawyer's duties to another current client, a former client, or a third person."¹¹⁷ This focuses on the correct issue, *the adequacy of the representation*. It is instructive to the courts and persons to be employed; it also illuminates what is to be disclosed. Connections or relationships are relevant if they concern or relate to the lawyer's own interests or duties to others which are logically relevant to whether the lawyer's proposed representation will be affected. It will then be up to the court, after considering the disclosed interests and relationships to determine whether there is a substantial risk of a material and adverse effect to the proposed representation. Required disclosures encompass those holdings and representational interests which currently render one not disinterested. But disclosure should be more extensive and encompass existing and former representational interests imposing duties on the lawyer, as well as any personal interests or duties to third parties which may impact on the representation.

It is the scope of the proposed representation which is the lodestar. Representation of a trustee or debtor-in-possession requires a variety of legal skills in large cases. Counsel must act not only as a general counsel but also as a specialist skilled in creditors' and debtors' rights and the Bankruptcy Code. Because a trustee and debtor-in-possession are fiduciaries, a lawyer representing any of them must also be knowledgeable as to their duties and be able to forthrightly advise them as to the performance of those duties during the pendency of the case.

114. 11 U.S.C. § 327(e).

115. 11 U.S.C. § 541(a).

116. 11 U.S.C. § 542 (West 1994 & Supp. 1997). For a discussion of the meaning of estate, see *supra* note 3.

117. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 201 (Proposed Final Draft No. 1, 1996).

An example is useful to recognizing a conflict in this context. Assume that a trustee wants to employ a lawyer to represent the trustee generally in a reorganization case. The lawyer has a current client, a creditor of the Chapter 11 debtor, whom it represents in matters unrelated to the Chapter 11 case, who is a creditor of the Chapter 11 debtor. Since the lawyer only *represents* the creditor, the per se disqualifications of the disinterested test are not involved. The lawyer can be employed so long as the representation of the creditor in an unrelated matter does not constitute the representation of an interest adverse to the estate or “does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor or an investment banker specified in subparagraph (B) or (C) of this paragraph, or for any other reason.”¹¹⁸ If the creditor client is owed \$1,000 for services furnished the debtor shortly prior to bankruptcy and there is no conceivable defense to the claim, the mere fact that a client in an unrelated matter is a creditor should not constitute an interest adverse to the estate.

On the other hand, if the creditor client is a major supplier who has been paid substantial amounts within ninety days of the filing of the bankruptcy case and has a contract to supply the debtor’s needs, an entirely different situation is presented. The trustee must exercise judgment in deciding whether the relationship is essential to the business of the debtor and, if so, whether the benefit of recovery of preferential payments outweighs the benefit of the relationship. In deciding how to proceed, the trustee must be advised as to whether the payments can be recovered and the impact on the ability to assume the contract. The lawyer will have to exercise judgment in rendering this advice. Thus, the lawyer and trustee must decide whether the representation of the creditor in unrelated matters will impact on the representation of the trustee by the lawyer.

But there is another complication. The lawyer may not be able to advise the trustee as to these matters since representation of the trustee in connection with the preferential payments and the assumption of the supply contract may be directly adverse to the supplier and, absent appropriate consent, is an impermissible conflict. Thus, the lawyer’s representation would be materially and adversely affected. If the supplier consents and the lawyer and trustee conclude that the representation of the trustee will not be adversely affected by the lawyers representation of the supplier, the court nonetheless must be satisfied that the lawyer’s diligence and zeal in representing the trustee will not be materially and adversely affected by the lawyer’s representation of the supplier in other matters. Consent by the supplier only avoids disqualification under the state rules.

118. 11 U.S.C. § 101(14)(E).

Is the analysis any different if the lawyer to be retained by the trustee also represents a stockholder, director, officer or employee of the debtor? It would seem not. The basic question is the same, whether there is a substantial likelihood that the representation of the trustee will be materially and adversely affected.

The prior examples concern representational relationships. But the personal interests of the lawyer may also be disqualifying. If the lawyer is the owner, general partner, secured creditor, officer or director of the debtor, is the analysis any different? Logically it should not be; again, we want to assure zealous and diligent representation.

Difficult problems are encountered in the area of multiple representation, either before or during the bankruptcy case. Courts often disqualify counsel for an entity in bankruptcy who also represents those in control prebankruptcy. Another troublesome issue for the courts is the representation of affiliated entities. Courts are torn between the undue expense and complication created by requiring separate counsel for each entity and the appearance of impropriety and potential conflicts inherent in such multiple representation.

As previously observed, there has been little guidance to bankruptcy courts and practitioners as to what is a conflict of interest. However, since the 1980s, the Business Bankruptcy Ethics Committee has focused attention on ethical issues confronting bankruptcy practitioners. Its work led to the recommendations of the House of Delegates of the American Bar Association that the per se disqualification rules of the disinterestedness standard be abandoned as to counsel for the debtor-in-possession and replaced by the requirement that counsel not hold or represent an interest materially adverse to the estate and meet the applicable standards of professional responsibility for the district in which the case is pending. The sole dissenter to the Ethics Subcommittee recommendations was Judge Bufford who believes that

[T]he debtor needs guidance from counsel who has no commitment to the prior debtor or to the business as usual prior to the filing of the bankruptcy case. Bankruptcy puts into jeopardy the very existence of the business enterprise. At this critical juncture in the life of the business, it is most in need of disinterested advice by counsel. It would be badly disserved by an advisor on the labyrinth of bankruptcy law who has a separate interest of his or her own to protect.

A lawyer who is interested in the outcome of a bankruptcy case is likely to give some attention, at least, to the protection of the lawyer's own interest in the outcome of the case, which may be to the detriment of the debtor's own interests. The avoidance of this potential (if not actual) conflict of interest is the purpose of the disinterestedness requirement of section 327.

....

I think that the balance struck by Congress in the Bankruptcy Code, in which it decided that a debtor may continue in possession but must be

represented by disinterested (and generally new) counsel, is a good balance that should not be upset.¹¹⁹

The problem with Judge Bufford's position is that Congress has already spoken; prior counsel for the debtor is not disqualified.¹²⁰ Judge Bufford's dissent is reminiscent of Judge Brandeis' view of his role in the *Lennox* case. It has been much discussed and has recently been revisited by Professor Spillenger.¹²¹ Brandeis' conduct in the *Lennox* case was the basis of one of the charges against his nomination to the Supreme Court.¹²²

119. Memorandum from Judge Samuel L. Bufford to Gerald K. Smith 2 (February 1, 1991) (on file with author) (concerning disinterestedness requirement for Chapter 11 debtor's counsel).

120. Judge Bufford overlooks the real problem, the representation of a debtor with fiduciary duties. Judge Matheson ably described this in *In re Amdura*, 121 B.R. 862 (Bankr. D. Colo. 1990) as follows:

Consider the role of the attorney, however. On the one hand, he is admonished that he must represent no conflicting interests. On the other, the Code itself creates nearly irreconcilable conflicts.

As noted above, the same attorney can represent both the debtor and the debtor-in-possession. It is the debtor which is given the exclusive ability to file a plan of reorganization during the first 120 days of the bankruptcy proceeding. 11 U.S.C. § 1121. And the Code clearly contemplates that the debtor can negotiate with the creditor groups to reduce or reallocate amounts flowing to creditor classes in order to effect a plan. In doing so, the debtor may even seek to preserve values to equity security holders when the "fair and equitable rule" would otherwise deny their participation. 11 U.S.C. § 1129(b). Does this not inherently place counsel in the position of representing conflicting interests? See, e.g., Ayer, *How to Think About Bankruptcy Ethics*, 60 American Bankruptcy Law Journal, 355, 391 (1986). One commentator has stated, in recognizing the inherently conflicting interests counsel is to represent:

I believe it to be substantially impossible to fully and fairly represent, as debtor-in-possession, the interests of the estate, the creditors, and the equity owners. Thus there is an inherent conflict in attempting to fulfill fully the duties of a trustee as well as the duties of a Chapter 11 debtor-in-possession. While this is not ethically unacceptable, it does seem to require the debtor-in-possession (and its counsel) to confront the nature of the tension and to be fair and open about which side of the line it is coming down on. Sigal, *Representation of Debtors-in-possession and Trustees—Disinterestedness and Adverse Interest Standards*, Publication at the 63rd Annual Meeting of the National Conference of Bankruptcy Judges, p. 8-27.

Id. at 865.

Judge Matheson focused on a related problem, the difficult position of counsel for the debtor-in-possession in *Amdura*: "The Court questions whether counsel can be said to be disinterested when they acknowledge their inability to take a position contrary to Continental because, at least as to W & S, it is unwilling to offend the 'hand that feeds.'" *Id.* at 867.

121. Clyde Spillenger, *Elusive Advocate: Reconsidering Brandeis as People's Lawyer*, 105 YALE L.J. 1445, 1502-11 (1996).

122. See John P. Frank, *The Legal Ethics of Louis D. Brandeis*, 17 STAN. L. REV. 683, 698-703 (1965).

A good share of any embarrassment Brandeis suffered over the *Lennox* case is due to his own use of what must have been one of the most unfortunate phrases he ever casually uttered. Sherman L. Whipple represented James Lennox in the bankruptcy proceedings. Whipple reported that when he asked Brandeis for whom the latter was counsel when he advised the assignment, Brandeis replied, "I should say that I was counsel for the situation."¹²³

What happened in the *Lennox* case is that Lennox and counsel for a major creditor of Lennox met with Brandeis to discuss the financial problems of Lennox. Brandeis did represent in unrelated matters a creditor of Lennox, although this was unknown to Brandeis at the time of the meeting. During the course of the meeting, it became apparent to all that Lennox was hopelessly insolvent, and Brandeis recommended an assignment for the benefit of creditors. Brandeis then inquired as to what Lennox and the lawyer for the creditor wanted Brandeis's firm to do. Lennox inquired as to whether Brandeis was to act as his counsel under the plan outlined by Brandeis. Brandeis replied "Not altogether as your counsel, but as trustee of your property."¹²⁴ Neither Mr. Frank nor Professor Spillenger conclude that Brandeis was guilty of any breach of ethics, but rather they conclude that Brandeis had not clearly communicated to Lennox what he intended. Professor Spillenger does suggest, however, that there was an obvious problem as to

the propriety of Brandeis's actions with respect to Lennox in light of the representation by Brandeis's firm of Weil, Farrell, one of the major creditors. In terms of the present-day approach represented by Rule 1.7 of the *Model Rules of Professional Conduct*, one might give Brandeis the benefit of the doubt by supposing that both Lennox and Weil, Farrell waived any objection they might have had to such simultaneous representation. Of course, this question begs the original one, which is whether Brandeis in fact undertook to serve Lennox as counsel.¹²⁵

Professor Spillenger went on to compare the views of two sets of writers. One set expounded the view "that Brandeis's actions were an effort to harmonize competing interests, to reach an accommodation that preserved a relationship rather than merely maximizing a private interest."¹²⁶ The other set viewed Brandeis as someone who encouraged "powerful corporate clients to comply with, not to undermine, regulations that serve important public values, and who otherwise urge[d] those clients to behave in socially

123. *Id.* at 702.

124. *Id.* at 699.

125. Spillenger, *supra* note 121, at 1507 n.213.

126. *Id.* at 1508.

responsible though not legally compelled ways.”¹²⁷ Under both views, “[t]he lawyer is thus counsel for a ‘situation’ formed by the formal client and the larger public world that gives the client’s behavior meaning.”¹²⁸

Mr. Spillenger, on the other hand, did not view Brandeis quite that sympathetically; instead, he viewed Brandeis as sensing a situation that he could solve

in the manner of a good Progressive problem-solver—or, in the words of one of my colleagues a ‘one-man New Deal’—and he sought to impose a solution that made reference less to the expressed desires of the parties involved than to a vision nurtured by and known only to himself.¹²⁹

This interesting episode in the professional life of one of the great lawyers of the Nineteenth and Twentieth Centuries brings into focus what many perceive as the role of counsel for the debtor-in-possession—it is as a “counsel for the situation.” It is true that under the ethical rules counsel must take direction from the client, but that does not mean that counsel should not transcend the parochial interests of the client. Counsel for the situation must be sensitive to the rights of all parties-in-interest and must seek a fair solution to the financial problems within the framework of the rights of the parties-in-interest.

The lawyer is thus counsel for a “situation” formed by the formal client and the larger public world that gives the client’s behavior meaning. Perhaps Brandeis’s actions followed this model: his instinct was that Lennox should not merely maximize his and his company’s interests but should do what was fair to all—in particular, to creditors. No doubt Brandeis would have argued that a policy of “paying 100 cents on the dollar” would also best serve Lennox’s interest, but the essence of Brandeis’s impulse was an argument from public morality, as he told Lennox at the interview:

My own feeling is that the best thing for you to do is not to be thinking too much of yourself, but thinking of the best interests of your creditors. If there is plenty there you have got it safe; if there is not, you will be in the position of having a fair, open, and aboveboard compromise; but I feel that it is for your interests as it is in accordance with good morals that you and your father should be just as frank and fair in the present situation as it is possible to be¹³⁰

127. *Id.* at 1509.

128. *Id.*

129. *Id.*

130. *Id.* at 1509 (quoting 2 ROY M. MERSKY & J. MYRON JACOBSTEIN, *THE SUPREME COURT OF THE UNITED STATES: HEARINGS AND REPORTS ON SUCCESSFUL AND UNSUCCESSFUL NOMINATIONS OF SUPREME COURT JUSTICES BY THE SENATE JUDICIARY COMMITTEE*, 794-95

B. *Other Rules of Professional Conduct Applicable in Bankruptcy Courts.*

Of considerable importance to lawyers involved in bankruptcy cases in districts other than those in the state in which they are admitted to practice are rules governing admission and professional conduct. No national rules governing admission and professional conduct have been promulgated under the Rules Enabling Act.¹³¹ Rules of conduct are governed by local rules of the bankruptcy courts, to the extent they are governed. The resulting lack of uniformity is a serious problem.

Patricia Channon of the Administrative Office of the United States Courts reviewed the local rules of the bankruptcy courts and found that most bankruptcy courts do not have a local rule concerning professional responsibility.¹³² Bankruptcy courts in thirty-five districts have no rule at all.¹³³ Bankruptcy courts for twenty-seven districts have adopted the district court rule, but provide no text of the adopted rule.¹³⁴ Bankruptcy courts for six districts specify the rules adopted by the highest court of the state in which the district is located.¹³⁵ Two courts impose standards which vary from those of the states in which the districts are located, although one of these districts has also adopted the state standard.¹³⁶ Of the districts that have a rule, one district requires that attorneys read and become familiar with the state bar's Rules of Professional Conduct, while another district encourages counsel to be familiar with the discovery guidelines of the state bar.¹³⁷

The recent study by the Federal Judicial Center for the Standing Committee canvassed the rules governing admission to practice and professional conduct of lawyers in the federal district courts.¹³⁸ The study established that rules as to bar membership in the district courts vary significantly among districts.¹³⁹ All but four districts allow lawyers admitted

(1977).

131. Rules Enabling Act of 1988, Pub. L. 100-702, 102 Stat. 4648.

132. Letter from Patricia S. Channon, Administrative Office of the United States Courts, to Gerald K. Smith, Advisory Committee on Bankruptcy Rules (April 4, 1997) (on file with author). However, nearly every bankruptcy court has a local rule as to who may practice before the court. Most of the latter rules required that the individual be admitted to the district court for the particular district in which the bankruptcy court was located.

133. *Id.* at 1.

134. *Id.*

135. *Id.*

136. *Id.* at 2.

137. *Id.* at Attachment 5.

138. MARIE CORDISCO, ELIGIBILITY REQUIREMENT FOR, AND RESTRICTIONS ON, PRACTICE BEFORE THE FEDERAL DISTRICT COURTS (1995) (unpublished table, on file with the author).

139. Every federal district court has a provision in its local rules listing criteria that an attorney must possess to be eligible to apply for admission to that court's Bar. Fifty-five (59%) federal district courts limit membership in its Bar to attorneys who are members of the bar of the state or territorial possession in which the district court is

to practice in another federal district court or before a state court to seek permission to appear *pro hac vice*. The four districts which do not allow such appearances have liberal bar membership rules.¹⁴⁰ The majority of districts allowing *pro hac vice* appearances require the association of "local counsel."¹⁴¹

Another recent report by Daniel Coquillette¹⁴² reviewed the local rules governing conduct for the ninety-four district courts. Slightly more than half or forty-eight of these districts "have adopted local rules and incorporate state standards in states that, in turn, have adopted some version of the *ABA Model Rules of Professional Conduct* (1983)."¹⁴³ Twelve districts or approximately thirteen percent had rules incorporating state standards from states which had some version of the 1969 ABA Code of Professional Responsibility.¹⁴⁴ The Eastern and Southern Districts of California adopted the California Rules of Professional Conduct.¹⁴⁵ Ten districts adopted rules referring to an ABA Model, four of which referred to the ABA Code, three to the Model Rules and one to both.¹⁴⁶ The Districts of Montana and the Southern District of Georgia even referred to the 1908 ABA Canons of Professional Ethics.¹⁴⁷ Ten districts referred to both an ABA Model and to state standards.¹⁴⁸ Eleven districts have no local rules governing attorney conduct, but a number of these districts have standing orders. One district followed neither state standards nor an ABA Model, but incorporated its own substantially modified version of the ABA Model Rules.¹⁴⁹

In a follow-up Study Coquillette discussed the considerable number of variances in the local rules. Coquillette concluded that a possible approach to more uniformity among local rules would be to adopt uniform federal rules for attorney conduct in several key areas, with other areas to be governed by state standards, was a possible approach to more uniformity.¹⁵⁰ "Obvious

located. . . .

Eligibility requirements in the remaining thirty-nine districts vary considerably, but some of them do fall into a number of patterns, all of which qualify a broader pool of applicants for admission.

Id. at 2-3 (footnotes omitted).

140. *Id.* at 4.

141. *Id.* at 5.

142. COQUILLETTE REPORT, *supra* note 69.

143. *Id.* at 4.

144. *Id.*

145. *Id.*

146. *Id.* at 4-5.

147. *Id.* at 5.

148. *Id.*

149. *Id.* at 5.

150. COQUILLETTE STUDY, *supra* note 70 at 5. As summarized in its methodology and finding sections, the initial phase of the Study was the design of a computer search of cases from

candidates for 'national' treatment would be . . . : (1) 'Conflict of Interest,' (2) 'Represented Parties,' (3) 'Lawyer as a Witness,' and (4) 'Fees.'"¹⁵¹ If a choice of law category were added, the Study noted that the proposed uniform federal rules would then cover the issues in almost ninety percent of all reported federal cases since 1990.¹⁵²

In a recent article, Professor Bruce Green demonstrates the need for certainty as far as the Rules of Professional Conduct to be applied in federal judicial proceedings.¹⁵³ His recommendation is that the federal judiciary "undertake rulemaking to develop a single set of highly detailed rules of professional conduct."¹⁵⁴

January 1, 1990 forward. Even that limited period led to a large number of cases, some 851. These cases were analyzed and sorted into 443 cases involving rules governing attorneys and 408 involving issues of attorney conduct in federal courts governed by Rule 11 and other standards. The largest category of rules involved were conflict of interest rules. "Rules Analogous to ABA Model Rules 1.7, 1.8, 1.9, 1.10 and 1.11 accounted for forty-six percent of reported federal disputes, or 204 cases of 443." Of these conflict cases, nearly eighty percent were civil in nature. *Id.* at 3-4.

151. *Id.* at 6.

152. *Id.*

153. Bruce A. Green, *Whose Rules of Professional Conduct Should Govern Lawyers in Federal Court and How Should the Rules Be Created?*, 64 GEO. WASH. L. REV. 460 (1996).

Traditionally, courts have been the principal lawmakers for lawyers. Over the past quarter century, pursuant to their supervisory authority over the legal profession, courts have filled this role by promulgating and enforcing sets of rules drafted by bar associations. Thus, in judicial proceedings within a particular state, lawyers' conduct is typically governed by a set of rules adopted by that state's judiciary based on a version of either the ABA *Model Rules of Professional Conduct* ("ABA Model Rules") or the predecessor ABA *Model Code of Professional Responsibility* ("ABA Model Code").

In federal judicial proceedings, however, the regulation of lawyers has been characterized by uncertainty and disharmony. The conduct of lawyers in federal proceedings is governed by the rules of the federal, not state, courts. The federal district courts, however, do not currently apply a uniform set of professional rules. Moreover, even rules that are substantially identical have been interpreted in vastly different ways by courts of different federal districts.

Id. at 462-64 (footnotes omitted).

154. *Id.* at 460.

In the light of these considerations, the most appropriate process for developing professional standards for federal practice is the obvious one that has been resisted by federal courts thus far: federal judicial rulemaking. The federal rulemaking process has a long history. Since the adoption of the Rules Enabling Act of 1934, the Supreme Court has promulgated rules of practice for federal court, beginning with the *Federal Rules of Civil Procedure* in 1938 and the *Federal Rules of Criminal Procedure* in 1946. Since 1958, principal responsibility for drafting federal rules of practice has been vested in the Judicial Conference, which acts through a Standing Committee on Rules of Practice and Procedure and various advisory committees.

While doubts have been raised about the Supreme Court's authority to adopt procedural rules pursuant to express federal authority, there would be little question

Mr. Eli J. Richardson also deplores the present, chaotic situation,¹⁵⁵ but

of its authority to adopt rules of professional conduct for lawyers in federal proceedings. As noted earlier, lower federal courts have done so even in the absence of explicit legislative authority. The problem, however, is that they have principally relied on imprecise bar association rules, rather than assuming responsibility for drafting detailed rules.

Rather than continuing to abdicate responsibility for the content of professional standards, the federal judiciary should develop independent standards through federal court rulemaking. Federal rules of professional conduct should apply in all federal judicial proceedings. These rules should comprehensively address lawyers' conduct as it relates to litigation. The obvious process for developing such rules would be a variant of the one by which federal courts promulgate rules of procedure, a process that has been refined over the course of more than sixty years and has proven successful.

Id. at 513-14 (footnotes omitted).

155. Eli J. Richardson, *Demystifying the Federal Law of Attorney Ethics*, 29 GA. L. REV. 137 (1994).

The federal system is no exception to this unfortunate state of affairs. It is the position of this Article that the federal law of attorney ethics, as developed and enforced almost exclusively by the federal courts, is plagued by myriad problems that prevent the formation of a cohesive and efficient structure of ethical rules. First, federal courts often fail to follow an identifiable set of attorney-ethics standards. Second, even if clearly identified, the governing attorney-ethics standards often are not interpreted properly by federal courts. Third, federal courts have failed to delineate clearly the proper place of governing attorney-ethics codes in the overall federal scheme of attorney ethics. Among other things, federal courts have not explained how and which factors beyond the black-letter rules contained in attorney-ethics codes are authoritative in resolving ethical dilemmas. Finally, federal courts often bypass excellent opportunities to issue authoritative ethics pronouncements that would clarify attorneys' ethical obligations.

The entrenched problems of federal attorney ethics pose more than just a theoretical quandary. Rather, this Article posits that they cause several undesirable practical consequences. First, they visit unfairness upon honest attorneys, who truly wish to comply with required ethical norms but cannot do so because they cannot determine what those norms are. Second, clients and the public also suffer. Clients pay for the increased time needed for their lawyers to research and address ethical issues arising in federal court, and the general public pays because its courts must spend precious time resolving ethical disputes. Third, these structural problems have the effect of discouraging scrutiny of the substantive content of both individual attorney-ethics rules and entire attorney-ethics codes, thus hindering progress toward the creation of an ideal set of ethical rules that best prescribes what lawyers can and cannot do.

Id. at 141-142 (footnotes omitted).

he recommends a district by district “shaping up,”¹⁵⁶ a solution different from Green and Coquillette.

The American Bar Association recently amended the Model Rules “in an attempt to provide clearer guidance to lawyers caught between conflicting ethical mandates.”¹⁵⁷ In a recent article, Susanna Felleman makes the case for further amendment but opts for continued state control.¹⁵⁸

In another recent article discussing the “patchwork quilt of ethical standards within the federal system” created by the United States Supreme Court treating “standards of professional ethics to be followed in the federal courts” as a “matter of federal law,” the authors conclude that the “solution is for the United States Supreme Court to promulgate a uniform federal rule providing that the ethical standards to be followed in any given district will be the ethical standards adopted by the highest court in the state in which the district sits, as amended and interpreted by the state court.”¹⁵⁹ The authors disagree with the Supreme Court’s dictum in *In re Snider*,¹⁶⁰ but point out that this is of no moment since Congress has expressly empowered “all federal courts . . . to ‘prescribe rules for the conduct of their business.’”¹⁶¹

The Conference of Chief Justices is a formidable opponent of a code of federal ethics. The fifty-one Chief Justices comprising The Conference recently resolved that each state remain exclusively responsible for regulating the professional conduct of the members of its bar.¹⁶²

156. *Id.* at 143.

[E]ach federal court would (1) identify in its local rules a code containing an exclusive list of the rules that govern attorneys’ conduct in the court; (2) adhere consistently to that code; (3) interpret that code in light of its variations from different codes and different versions of the same code; (4) allow attorneys to engage in all conduct not prohibited by the governing code, but construe the code’s more flexible provisions to prohibit unusual forms of egregious conduct; (5) clarify that attorneys cannot rely on their good-faith judgment to resolve an ethical dilemma; and (6) invariably resolve ethical issues raised by motions to disqualify.

Id. (footnotes omitted).

157. Susanna Felleman, Note, *Ethical Dilemmas and the Multistate Lawyer: A Proposed Amendment to the Choice-of-Law Rule in the Model Rules of Professional Conduct*, 95 COLUM. L. REV. 1500, 1501 (1995).

158. *Id.* at 1524. Ms. Felleman’s concern about a federal code of ethics appears to be based on the assumption it would “apply to lawyers practicing in both state and federal courts,” *id.* at 1521, and that “state bar associations and state courts would be eliminated from the regulatory loop.” *Id.*

159. Philip K. Lyon & Bruce H. Phillips, *Professional Responsibility in Federal Courts, Consistency is Cloaked in Confusion*, 50 ARK. L. REV. 59, 74 (1997).

160. 472 U.S. 634 (1985).

161. Lyon & Phillips, *supra* note 159, at 71.

162. COQUILLETTE STUDY, *supra* note 70 at 33. In *Leis v. Flynt*, 439 U.S. 438 (1979), the Court observed that “[s]ince the founding of the Republic, the licensing and regulation of lawyers has been left exclusively to the States and the District of Columbia within their respective jurisdictions. The States prescribe the qualifications for admission to practice and the standards

C. *American Bar Association Rules of Professional Conduct.*

The American Bar Association has promulgated three codes of ethics this century. The first, the ABA Canons of Professional Ethics ("Canons"), was promulgated in 1908. The second, the ABA Model Code of Professional Responsibility ("Model Code"), was promulgated in 1969. The third, the ABA Model Rules of Professional Conduct ("Model Rules"), was promulgated in 1983.

The conflict rules of the Canons are contained in Canon 6.¹⁶³ Under Canon 6, a lawyer has a conflict when he has a duty for one client to contend for something he must oppose for another client. The Canon also precludes representation adverse to a former client "with respect to which confidence [was] . . . reposed."¹⁶⁴

The Model Code dropped the Canon's former client rule and more clearly expressed the current client rule. Apparently the ABA thought that the former client was adequately covered by Canon 4 which requires a lawyer to protect client confidences¹⁶⁵ and secrets and by Canon 9 which requires a lawyer to avoid any appearance of impropriety.¹⁶⁶

As far as the current client rule, Ethical Consideration 5-14 admonishes that:

Maintaining the independence of professional judgment required of a lawyer precludes his acceptance or continuation of employment that will adversely affect his judgment on behalf of or dilute his loyalty to a client. This problem arises whenever a lawyer is asked to represent two or more

of professional conduct." *Id.* at 442. In *Nix v. Whiteside*, 475 U.S. 157 (1986), the Court observed that a court must be careful not to intrude into the State's proper authority to define and apply standards of professional conduct applicable to those it admits to practice in its courts.

163. It is the duty of the lawyer at the time of retainer to disclose to the client all the circumstances of his relations to the parties, and any interest in or connection with the controversy, which might influence the client in the selection of counsel.

It is unprofessional to represent conflicting interests, except by express consent of all concerned given after a full disclosure of the facts. Within the meaning of this canon, a lawyer represents conflicting interests when, in behalf of one client, it is his duty to contend for that which duty to another client requires him to oppose.

The obligation to represent the client with undivided fidelity . . . forbids also the subsequent acceptance of retainers or employment from others in matters adversely affecting any interest of the client with respect to which confidence has [sic] been reposed.

CANONS OF PROFESSIONAL ETHICS Canon 6 (1908).

164. *Id.* The current client rule, although seemingly clear, apparently was not understood to preclude a lawyer suing a current client as an unrelated matter until the *Rottnier* decision in 1964.

165. ANNOTATED CODE OF PROFESSIONAL RESPONSIBILITY Canon 4 (1979).

166. *Id.* at Canon 9.

clients who may have differing interests, whether such interests be conflicting, inconsistent, diverse, or otherwise discordant.¹⁶⁷

Disciplinary Rule 5-105(A) precludes a lawyer from accepting employment if the “exercise of his independent professional judgment in behalf of a client will be or is likely to be adversely affected by the acceptance of the proffered employment, or if it would be likely to involve him in representing differing interests,”¹⁶⁸ absent appropriate consent. Disciplinary Rule 5-105(B) precludes multiple employment “if the exercise of [the lawyer’s] independent professional judgment in behalf of a client will be or is likely to be adversely affected by [the lawyer’s] representation of another client, or it would be likely to involve [the lawyer] in representing differing interests.”¹⁶⁹

The Model Rules of Professional Conduct cover the former client rule in Rule 1.9. “A lawyer who has formerly represented a client in a matter shall not thereafter represent another person in the same or a substantially related matter in which that person’s interests are materially adverse to the interests of the former client,”¹⁷⁰ absent appropriate consent. The example given in the comments relates to a lawyer who drafted a contract on behalf of the former client; the lawyer would be precluded from seeking to rescind the contract on behalf of a new client.¹⁷¹

As for the present client, Rule 1.7(a) precludes representation of a client “if the representation of that client will be directly adverse to another client,”¹⁷² absent appropriate consent. Rule 1.7(b) precludes representation of “a client if the representation of that client may be materially limited by the

167. *Id.* at EC 5-14.

168. *Id.* at DR 5-105(A).

169. *Id.* at DR 5-105(B). The Annotated Code of Professional Responsibility observes the obvious, that

Current DR 5-105 does not contain [as clear a definition as Canon 6] of the conduct that is permitted or proscribed under it. It prescribes, instead, a test for determining whether it is proper for a lawyer to represent a client; this test consists in effect of the lawyer’s analyzing his or her own state of mind regarding whether a given representation will so affect ‘his independent professional judgment’ as to affect or to be likely to affect the interests of another client adversely.

Id. at DR 5-105 note (Textual and Historical Notes). The Annotated Code points out that:

DR 5-105 concerns itself with the adverse effect that competing interests of more than one client have on the attorney’s loyalty to and exercise of professional judgment on behalf of each client (EC 5-14). An attorney should not be placed in a position in which, even unconsciously, he or she will be tempted to “soft pedal” zealous representation for one client in order to avoid an obvious clash with another.

Id. at DR 5-105 cmt. (citation omitted).

170. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.9(a) (1995).

171. *Id.* at Rule 1.9 cmt. 1.

172. *Id.* at Rule 1.7(a).

lawyer's responsibilities to another client or to a third person, or by the lawyer's own interests,"¹⁷³ absent appropriate consent.

Comment 3 to Rule 1.7 summarizes the current client rules, from the perspective of the client in the unrelated matter.

As a general proposition, loyalty to a client prohibits undertaking representation directly adverse to that client without that client's consent. Paragraph (a) expresses that general rule. Thus, a lawyer ordinarily may not act as advocate against a person the lawyer represents in some other matter, even if it is wholly unrelated. On the other hand, simultaneous representation in unrelated matters of clients whose interests are only generally adverse, such as competing economic enterprises, does not require consent of the respective clients.¹⁷⁴

The other side of the coin is captured in Comment 4 to Rule 1.7(b).

Loyalty to a client is also impaired when a lawyer cannot consider, recommend or carry out an appropriate course of action for the client because of the lawyer's other responsibilities or interests. The conflict in effect forecloses alternatives that would otherwise be available to the client. Paragraph (b) addresses such situations. A possible conflict does not itself preclude the representation. The critical questions are the likelihood that a conflict will eventuate and, if it does, whether it will materially interfere with the lawyer's independent professional judgment in considering alternatives or foreclose courses of action that reasonably should be pursued on behalf of the client. Consideration should be given to whether the client wishes to accommodate the other interest involved.¹⁷⁵

Rule 1.7(b) only requires the consent of the current client, not the consent of the client in the unrelated matter. The reasoning behind this consent requirement is Rule 1.7(b)'s assumption that the lawyer will adhere to the prohibition of Rule 1.7(a) and the assumption that the lawyer will not do anything directly adverse to the client in the unrelated matter. Conversely, Rule 1.7(a) requires consent of both the current client and the client in the unrelated matter if the lawyer takes on a representation directly adverse to the client in the unrelated matter. Here, we clearly see the juxtaposition of the interests of the proposed client and the client in the unrelated matter. The duty of loyalty precludes the lawyer from being directly adverse to the client in the unrelated matter and also precludes lawyer from accepting the proposed representation due to the limited nature of the effectiveness of the proposed

173. *Id.* at Rule 1.7(b).

174. *Id.* at Rule 1.7 cmt. 3.

175. *Id.* at Rule 1.7 cmt. 4.

representation. According to the Comment representation of the new client impairs the loyalty to the proposed client because the lawyer “cannot consider, recommend or carry out an appropriate course of action for the client because of the lawyer’s [duty to the client in the unrelated matter].”¹⁷⁶ The Comment adds that this is not a per se disqualification, but rather a disqualification if there is a “likelihood that a conflict will eventuate and, if it does, . . . it will materially interfere with the lawyer’s independent professional judgment in considering alternatives or foreclose courses of action that reasonably should be pursued on behalf of the client.”¹⁷⁷ Rule 1.7(a) applies both to litigation¹⁷⁸ and nonlitigation matters.¹⁷⁹

In *The Law of Lawyering* by Hazard and Hodes, there is a discussion of Model Rule 1.7.¹⁸⁰

The prohibition in Rule 1.7(a) against representation of clients whose interests are “directly” adverse implies that concurrent representation of clients whose interests are only “indirectly” or “generally” adverse is not prohibited (at least by [Rule 1.7(a)]). . . .

. . . .

The question is always whether the same lawyer may serve both clients loyally. At one end of the continuum of conflict situations are those where the lawyer may serve the respective clients without their individual consent because the transactions are quite distinct. At an intermediate point are situations where the lawyer may represent both clients only with the consent of each because the legal aspects of the transactions are substantially related and entail client interests that are adverse. At the other end of the continuum are situations where concurrent representation is impermissible even with client consent, because the conflict is so intense that concurrent representation is impermissible even if client consent could be obtained. The law deems these situations to be “nonconsentable,” because the conflict is so intense that an impaired relationship with one or more of the clients is inevitable, so that the lawyer herself should veto concurrent representation. . . .

Where, then, should the lines be drawn? Certainly adverse positions in litigation should be *sufficient* to make a conflict “direct.” A lawyer should not be allowed to sue an individual client on behalf of another present client, even if the lawyer represents the first client in a wholly unrelated matter, such as drafting his will. This follows, because the focus of Rule

176. *Id.*

177. *Id.*

178. *See id.* Rule 1.7 cmt. 7.

179. *See id.* Rule 1.7, cmt. 11.

180. 1 GEOFFREY C. HAZARD, JR. & W. WILLIAM HODES, *THE LAW OF LAWYERING: A HANDBOOK ON THE MODEL RULES OF PROFESSIONAL CONDUCT* § 1.7:100-300 (2d ed. 1997).

1.7(a) is on impairment of the client-lawyer *relationship*, and it is unreasonable to postulate trusting relationships under those conditions.¹⁸¹

The Treatise states that the strong presumption against concurrent representation of clients with direct conflicting interests is warranted due to the need to avoid two main dangers: "First, that confidential information will 'leak' from one camp to the other; second, that clients and the public at large will be disturbed by the sight of one lawyer disloyally 'playing both sides of the street,' earning two fees, and possibly pulling his punches."¹⁸²

Both the Model Code and the Model Rules allow conflicting representation under certain circumstances with the consent of both clients. Model Code Disciplinary Rule 5-105(C) allows the representation but only if "it is obvious"¹⁸³ that the lawyer "can adequately represent the interest of each"¹⁸⁴ client and both clients consent after "full disclosure of the possible effect"¹⁸⁵ of the representation on the exercise of independent professional judgment on behalf of each client. Model Rule 1.7(a) allows conflicting representation to be taken on if the lawyer reasonably believes the representation "will not adversely affect the relationship with the other client"¹⁸⁶ and "each client consents after consultation."¹⁸⁷

The Model Code defines differing interest as any interest adversely affecting either the lawyer's judgment or loyalty to a client. The Model Rules do not define adverse interest, apparently satisfied that the phrase "directly adverse"¹⁸⁸ is self-explanatory. The *Lawyer's Manual on Professional Conduct* points out that the very broad proscription of Model Rule 1.7 is not as absolute as it seems, however.

181. *Id.* § 1.7:203, at 232.15-233 (footnotes omitted).

In any event, a *per se* ban in cases of direct conflict of interest would be in keeping with the letter of the Code language which Rule 1.7(a) replaces, although the precise meaning of the Code on this point has never been clear. DR 5-105(C) permitted a lawyer to undertake concurrent representation when it was "obvious" that he could "adequately" represent each client's interests. Besides being awkward, this odd language was hard to apply in practice, for a lawyer sensitive enough to spot the problem would hardly think it "obvious" that a direct conflict could be made to go away. In practice, therefore, DR 5-105(C) also contemplated something akin to a *per se* rule.

Id. § 1.7:207, at 237.

182. *Id.* § 1.7:207, at 237.

183. ANNOTATED CODE OF PROFESSIONAL RESPONSIBILITY DR 5-105(C) (1979).

184. *Id.*

185. *Id.*

186. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.7(a) (1995).

187. *Id.*

188. *Id.* at Rule 1.7(a).

The language in the Model Rule refers to representation that is “directly adverse” to another client. Clearly there is direct adversity where two clients are in litigation against each other. But moving away from that bright line example the determination becomes more difficult. The Comment to the Rule suggests that the other end of the continuum is the situation where a lawyer represents clients that are “economic enterprises with generally competing interests” against one another in unrelated matters. In that situation, the conflict is so diffused and general that client consent is not even required. In between these extremes are many other possible situations which must be analyzed individually to see if they present direct adversity.¹⁸⁹

The *Lawyer's Manual on Professional Conduct* concludes that the duty of loyalty as well as concern for the vigor of the lawyer's representation of two adverse clients are the bases for Rule 1.7.¹⁹⁰ The *Lawyer's Manual* relies on *Cinema 5, Ltd. v. Cinerama, Inc.*¹⁹¹ and *Avacus Partners L.P. v. Brian*¹⁹² to demonstrate the importance of the duty of loyalty.¹⁹³ In *Cinema 5*, the court held that, where employment is accepted against an existing client, disqualification is based on the duty of undivided loyalty.¹⁹⁴ The court in *Avacus* disqualified a firm under the Model Rules even though simultaneous conflicting representations were not involved. The *Avacus* court found it enough that the representation was directly adverse to the interest of a current client.¹⁹⁵

Similarly, in *Glueck v. Jonathan Logan, Inc.*,¹⁹⁶ the court disqualified the law firm even though no direct conflict existed. The plaintiff in *Glueck* sued for breach of an employment contract. The defendant moved to disqualify the lawyer for plaintiff because the lawyer's firm represented a trade association that negotiated collective bargaining agreements on behalf of its members, including the defendant.¹⁹⁷ The Second Circuit found “sufficient aspects of an attorney-client relationship”¹⁹⁸ to trigger inquiry into the

189. AMERICAN BAR ASS'N & THE BUREAU OF NAT'L AFFAIRS, INC., *LAWYER'S MANUAL ON PROFESSIONAL CONDUCT* 51:103-104 (1997).

190. *Id.*; see also *Fund of Funds, Ltd. v. Arthur Andersen & Co.*, 567 F.2d 225, 232-33 (2d Cir. 1977); *Jeffry v. Pounds*, 136 Cal. Rep. 373, 376 (Ct. App. 1977).

191. 528 F.2d 1384 (2d Cir. 1976).

192. *Avacus Partners L.P. v. Brian* (Del. Ch. Jan. 23, 1990) in 16 DEL. J. CORP. L. 247 (1991).

193. AMERICAN BAR ASS'N & THE BUREAU OF NAT'L AFFAIRS, INC., *supra* note 189, at 51:104-105.

194. *Cinema 5*, 528 F.2d at 1386.

195. *Avacus*, 16 DEL. J. CORP. L. at 252.

196. 653 F.2d 746 (2d Cir. 1981).

197. *Id.* at 748.

198. *Id.* at 749.

potential conflict of interest involved in the lawyer's role as plaintiff's counsel in the case.¹⁹⁹

D. *Restatement (Third) of the Law Governing Lawyers.*

The American Law Institute has labored for over a decade to "express clearly and completely the legal rules and doctrines that courts apply [to lawyers] . . . and to explain the basis for those rules and doctrines"²⁰⁰ in its *Restatement*. Chapter 8 of the *Restatement* restates the law of conflicts. The basic rule is that "a lawyer may not represent a client if the representation would involve a conflict of interest."²⁰¹ A conflict exists "if there is a substantial risk that the lawyer's representation of the client would be materially and adversely affected by the lawyer's own interests or by the lawyer's duties to another current client, a former client, or a third person."²⁰² More specific conflict rules are applications of this basic rule,²⁰³ with the exception of the rule precluding suit against an existing client.²⁰⁴

As will become evident in the discussion of conflict issues in workouts and reorganizations, the conflicts sections of the *Restatement* are instructive. However, there is an important, unresolved issue. All agree that a lawyer may not assert a claim against or defend against a claim of a client in an unrelated matter. This is precluded by section 209(2). However, there is sharp disagreement as to whether section 209(2) or section 201 should apply to the bankruptcy case as a whole.

This sharp disagreement may seem odd to some considering that all agree that a lawyer has a duty of loyalty to a client. However, it is doubtful that it was ever an absolute duty, and its less than absolute nature is recognized by the current drafts of the *Restatement*. The American Law Institute in its *Second Restatement of the Law on Agency* concluded that the duty of loyalty is limited by the scope of the agency.²⁰⁵ Under this approach a lawyer could be

199. *Id.*

200. Wolfram, *supra* note 60, at 196.

201. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 201 (Proposed Final Draft No. 1, 1996).

202. *Id.*

203. Those of particular relevance to bankruptcy cases are section 206, Lawyer's Personal Interest Affecting Representation of Client, section 209, Representing Parties With Conflicting Interests in Civil Litigation, section 211, Multiple Representation in Non-Litigated Matter, § 212, Conflicts of Interest in Representing Organization, section 213, Representation Adverse to Interest of Former Client, and section 216, Lawyer With Fiduciary or Other Legal Obligation to Third Person.

204. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 209(2) (Proposed Final Draft No. 1, 1996).

205. RESTATEMENT (SECOND) OF AGENCY § 394 (1958). "Unless otherwise agreed, an agent
<https://scholarcommons.sc.edu/sclr/vol48/iss4/5>

adverse to the client as to a matter outside the scope of the representation. But this common law rule has been altered as a result of the widespread adoption of the Model Code and Model Rules. The Model Code provides that "[a] lawyer shall decline proffered employment . . . if it would be likely to involve him in representing differing interests."²⁰⁶ The Model Rules preclude representation of a client "if the representation of that client will be directly adverse to another client."²⁰⁷ Comment 1 to Rule 1.7 implies that the rule is grounded in the duty of loyalty.²⁰⁸

In the current drafts of the *Restatement*, the duty of loyalty is reaffirmed but subtly changed. Comment b to section 201 of the *Restatement* makes it clear that underlying the basic conflict rule of the *Restatement* is the lawyer's duty of loyalty to the client.

A client is entitled to be represented by a lawyer whom the client can trust. Instilling such confidence is an objective important in itself. For example, the principle underlying the prohibition against a lawyer's filing suit against a present client in an unrelated matter (see § 209 Comment e) may also extend to situations, not involving litigation, in which significant impairment of a client's expectation of the lawyer's loyalty would be similarly likely. Contentious dealings, for example involving charges of bad faith against the client whom the lawyer represents in another matter would raise such a concern. So also would negotiating on behalf of one client when a large proportion of the lawyer's other client's net worth is at risk.²⁰⁹

is subject to a duty not to act or to agree to act during the period of his agency for persons whose interests conflict with those of the principal in matters in which the agent is employed." *Id.*

206. ANNOTATED CODE OF PROFESSIONAL RESPONSIBILITY DR 5-105(A) (1979). A differing interest is defined in the Model Code as an "interest that will adversely affect either the judgment or the loyalty of a lawyer to a client, whether it be a conflicting, inconsistent, diverse, or other interest." *Id.* at 454, Definition 1. While Disciplinary Rule 5-105(A) precludes new employment, Disciplinary Rule 5-105(B) provides the same protection against continued multiple employment. In both situations the problem can be solved by informed consent.

207. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.7(a) (1995). Model Rule 1.7(a) precludes representation of a client directly adverse to another client. Rule 1.7(a) is not limited to conflicts in litigation.

208. *Id.* at Rule 1.7 cmt. 1.

Loyalty is an essential element in the lawyer's relationship to a client. An impermissible conflict of interest may exist before representation is undertaken, in which event the representation should be declined. The lawyer should adopt reasonable procedures, appropriate for the size and type of firm and practice, to determine in both litigation and non-litigation matters the parties and issues involved and to determine whether there are actual or potential conflicts of interest.

Id.

209. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 201 cmt. b (Proposed Final Draft No. 1, 1996).

Section 209 sets forth conflict rules for civil litigation. Section 209 covers (1) representation of two or more clients as co-clients involved in the same litigation and (2) representation of a client in asserting or defending a claim against another client. Again, the comments make it clear that a basis for Section 209 is the duty of loyalty.

Fundamental conflicts of loyalty and threats to client confidentiality would be inevitable if a lawyer were to represent clients opposing each other in the same litigation. Many actions that the lawyer took on behalf of one client would have the potential for being at the expense of the other. Furthermore, the public interest in the orderly management of litigation could be seriously compromised. Thus, the same lawyer may not represent both plaintiff and defendant in a breach of contract lawsuit, for example.²¹⁰

. . . .

[T]he lawyer has a duty of loyalty to the client being sued. Moreover, the client on whose behalf suit is filed might fear that the lawyer would pursue that client's case less effectively out of deference to the other client. Thus, a lawyer may not sue a current client on behalf of another client, even in an unrelated matter, unless consent is obtained under the conditions and limitations of § 202.²¹¹

Section 209(2) of the *Restatement* provides that "a lawyer in civil litigation may not . . . represent one client in asserting or defending a claim against another client currently represented by the lawyer, even if the matters are not related."²¹² Although the duty of loyalty is absolute as to civil suits involving clients asserting claims against each other, the duty is not absolute as to clients adverse to each other in a context other than that of civil litigation. Section 201 allows a lawyer to represent one client in a transaction with another client represented in unrelated matters unless there is a substantial risk that the client represented would not be adequately represented in some material way.²¹³

The treatment of the duty of loyalty in section 201 is in sharp contrast to how the duty is treated in section 209. Section 209 focuses on the duty of loyalty to the client represented in unrelated matters, while section 201 focuses on the adequacy of the representation of the client represented. Section 201's only expression of concern for the client in unrelated matters is the statement in comment b that some situations may result in a "significant impairment of

210. *Id.* § 209 cmt. c.

211. *Id.* § 209 cmt. e.

212. *Id.* § 209.

213. *Id.* § 201.

a client's expectation of the lawyer's loyalty."²¹⁴ If so, counsel is disqualified from representing the client, not because of the injured feelings or impairment of the expectation of the lawyer's loyalty to the client in the unrelated matter, but because the duties to the client in the unrelated matter may materially and adversely affect the representation of the client. The focus of the basic conflict rule of section 201 is whether the personal interest of the lawyer or the lawyer's duties to others will inhibit the representation of the client. See, for example, comment d, entitled "Representation of Client."

In yet other situations, the conflict of interest arises because the circumstances indicate that the confidence that a client reasonably reposes in the loyalty of a lawyer would be compromised due to the lawyer's relationship with another client or person whose interests would be adversely affected by the representation.²¹⁵

Somewhat opaquely comment d refers to the impact on the expectation of loyalty of the client in the unrelated matter. "The prohibition of conflicts of interest ordinarily restricts a lawyer's activities only where those activities materially and adversely affect the lawyer's ability to represent a client including such an effect on a client's reasonable expectation of the lawyer's loyalty."²¹⁶

Section 28 of the *Restatement* lists the duties of a lawyer to a client, but the black letter rule does not mention the duty of loyalty:

To the extent consistent with the lawyer's other legal duties and subject to the other provisions of this Restatement, a lawyer must, in matters within the scope of the representation:

- (1) proceed in a manner reasonably calculated to advance a client's lawful objectives, as defined by the client after consultation;
- (2) act with reasonable competence and diligence;
- (3) comply with obligations concerning the client's confidences and property, avoid impermissible conflicting interests, deal honestly with the client, and not employ advantages arising from the client-lawyer relationship in a manner adverse to the client; and
- (4) fulfill valid contractual obligations to the client.²¹⁷

214. *Id.* § 201 cmt. b.

215. *Id.* § 201 cmt. d.

216. *Id.*

217. *Id.* § 28.

Comment e to section 28 states that “[t]he responsibilities entailed in promoting the objectives of the client may be broadly classified as duties of loyalty.”²¹⁸ The concluding paragraph of comment e states that “[t]he duties of loyalty are subject to exceptions described elsewhere in this *Restatement*. Those exceptions typically protect the concerns of third persons and the public or satisfy the practical necessities of the legal system.”²¹⁹ The Reporter’s Note to comment e refers to other Reporters’ Notes on the duties of loyalty; however, a review of the references does not reveal any discussion of the duty of loyalty except for that found in section 111 on confidential information and in the conflicts chapter.²²⁰

The basic prohibition of conflicts of interest in section 201 not only fails to mention the duty of loyalty, but it also defines a conflict of interest from the perspective of the client to be represented: “A conflict of interest is involved if there is a substantial risk that the lawyer’s representation of the client would be materially and adversely affected by the lawyer’s own interests or by the lawyer’s duties to another current client, a former client, or a third person.”²²¹ Nonetheless, comment b interprets section 201 as precluding proposed representation if it would result in a significant impairment of the expectation of the lawyer’s loyalty of the client in unrelated matters. But under section 201 this is so, only if the duty of loyalty to the client in an unrelated matter would materially and adversely affect the proposed representation. If section 201 is intended to state the nonlitigation correlative of the litigation rule of section 209(b), it could be accomplished better by separate rule. Such a rule might look like this:

Unless all affected clients consent to the representation under the limitations and conditions provided in section 202, a lawyer may not represent a client if the representation would significantly impair another client’s expectation of the lawyer’s loyalty.

A comment to this section would contain the relevant commentary in comment b to section 201 as follows: “Contentious dealings, for example involving charges of bad faith against the client whom the lawyer represents in another matter would

218. *Id.* § 28.

219. *Id.* § 28 cmt. e.

220. The Reporter’s Note cross-references sections 44, 53, 56-58, 72, 111, 112 and 201-214. Section 111 defines confidential client information. Comment b thereto states that “[a] client’s approach to a lawyer for legal assistance implies that the client trusts the lawyer to advance and protect the interests of the client (see § 28(1)). The resulting duty of loyalty is the predicate of the duty of confidentiality.” *Id.* § 111 cmt. b.

221. *Id.* § 201.

raise such a concern. So also would negotiating on behalf of one client when a large proportion of the lawyer's other client's net worth is at risk."²²²

Confusion could also be avoided by transferring to this new section the following commentary from comment c(iii) to section 201:

General antagonism between clients does not necessarily mean that a lawyer would be engaged in conflicted representations by representing the clients in separate, unrelated matters. A conflict for a lawyer ordinarily exists only when there is conflict in the interests of the clients that are involved in the matters being handled by the lawyer or when unrelated representations are of such a nature that the lawyer's relationship with one or both clients likely would be adversely affected.²²³

It would also be an improvement if illustration 5 to section 201 were transferred to an appropriate place in the comments to section 209. Illustration 5 focuses on the right of the client in the unrelated matter to disqualify the attorney, rather than on disqualification based on any material or adverse effects on the duty to the client in the unrelated matter.

Comment b to section 209 deals with conflicts among current clients. It states that four fundamental and sometimes competing values must be reconciled. One of those is "the client's faith in the lawyer's loyalty."²²⁴ The comment points out that the client's faith in the lawyer's loyalty will be severely tried whenever the lawyer must be loyal to another client whose interests are materially adverse.

Comment c to section 209 talks about clients who are aligned in opposition to each other. It states that "[f]undamental conflicts of loyalty and threats to client confidentiality would be inevitable if a lawyer were to represent clients opposing each other in the same litigation."²²⁵ A lawyer cannot sue another client because "the lawyer has a duty of loyalty to the client being sued."²²⁶

Section 211 precludes multiple representation in a nonlitigation setting if there is a substantial risk that the lawyer's representation of one or more of the clients would be materially and adversely affected by the lawyer's duties to one or more of the other clients. Comment b to section 211 states that "[a]s in litigated cases, multiple representation not involving litigation requires the lawyer to remain loyal to clients."²²⁷

222. *Id.* § 201 cmt. b.

223. *Id.* § 201 cmt. c(iii).

224. *Id.* § 209 cmt. b.

225. *Id.* § 209 cmt. c.

226. *Id.* § 209 cmt. e.

227. *Id.* § 211 cmt. b.

Although the *Restatement* considers the duty of loyalty as a rationale for the basic conflict rule, it is fully implemented only in section 209. And the suggestion in comment b to section 201 that “[c]ontentious dealings, for example involving charges of bad faith against the client whom the lawyer represents in another matter would raise such a concern,”²²⁸ seemingly requires a significant impairment of a client’s expectation of the lawyer’s duty of loyalty. In contrast, section 209, in the context of bilateral litigation, prohibits the representation of one client in asserting or defending a claim against another client currently represented by the lawyer in an unrelated matter.²²⁹ However, comment b to section 209 focuses on the loyalty to the client represented in the litigation, not the client being sued who is represented in the unrelated matter: “[T]he client’s faith in the lawyer’s loyalty to the client’s interests will be severely tried whenever the lawyer must be loyal to another client whose interests are materially adverse.”²³⁰ Although the result is the same, from the perspective of the client who is being sued, it is hardly a refreshing commentary on the ethics of the profession to focus on the client who is suing!

As we have seen, the *Restatement* treats the duty of loyalty as absolute in so far as the litigation rule, but flexible in other contexts. Perhaps the explanation for this schizophrenic approach is disagreement among the Reporters. In *Suing a Current Client*,²³¹ Professor Thomas D. Morgan, the Associate Reporter responsible for the Conflicts Chapter of the *Restatement*, poses the hypothetical situation of a law firm acting as local counsel for a national manufacturing company. The firm represents the company solely as to file written protests of local property tax assessments. The firm regularly represents an individual who periodically sells small amounts of office supplies to the company. The company has redrafted its purchase order and the local supplier consults the firm as to the meaning of the terms in the new purchase order.²³² Professor Morgan asserts that no conflict exists and that the consent of the company is not required for the representation of the local client, but he points out that “some of my colleagues vigorously disagree[.]”²³³ Professor Morgan appears to have prevailed as far as the nonlitigation rule. Section 201 is not a per se disqualification, but rather a disqualification based not on the breach to the client in unrelated matters, but substantial risk that the duty of loyalty to the client in the unrelated matters will materially and adversely affect the representation of the long-time client.

228. *Id.* § 201 cmt. b.

229. *Id.* § 209(2).

230. *Id.* § 209 cmt. b.

231. Thomas D. Morgan, *Suing a Current Client*, 1 J. INST. FOR STUDY LEGAL ETHICS 87 (1996).

232. *Id.* at 91.

233. *Id.*

Professor Morgan would like to change the litigation rule as well, but those opposing his opinion have prevailed;

This essay will argue that the rule should stop short of a categorical prohibition against a lawyer's filing suit against a current client.

A "substantial relation" between the cases should not be required; that test goes primarily to protection of confidential information and more than that is at stake in these cases, but I believe a single rule is being used today to deal with two quite different issues,

First, in the case of the client being sued by "its" lawyer, the question should be whether a reasonable client in the circumstances of the case would perceive a breach of loyalty, "loyalty" being understood as more than exclusively a financial concept.

Second, in the case of the client on whose behalf suit is brought, the test should be whether there is a credible basis for believing the lawyer may not represent that client wholeheartedly out of a desire to preserve good relations with the client being sued.

At minimum, courts should require a showing that the proposed suit against a current client will have a "material" adverse effect on representation of one or both current clients before prohibiting or sanctioning the representation.

The approach suggested here would require an exercise of judgment that might seem to provide less certainty and predictability than a categorical prohibition would produce, but I believe that in the case of this rule, the opposite would prove true.²³⁴

234. *Id.* at 94. In *Suing a Current Client: A Response to Professor Morgan*, Mr. Brian J. Redding, loss prevention counsel with Attorneys' Liability Assurance Society ("ALAS"), concurs with Professor Morgan's criticism of Model Rule 1.7(a), but suggests a different solution.

As Professor Morgan demonstrates in his article, the rule prohibiting suing a current client evolved over a period of decades. During most of that time, the practice of law was far different from what it is today. To highlight the problems literal application of Model Rule 1.7(a) can cause, Professor Morgan hypothesizes [sic] a firm being asked to bring a run-of-the-mill products liability case against a large corporation for whom others in the firm are doing property tax assessment work. I have seen even more egregious examples: A client for whom a firm branch office lawyer is handling a small (often one-shot) matter sues a long-time client of the firm's main office (on an unrelated matter) and objects to the firm representing its long-time client. Such examples, particularly in the world of large law firms, are a daily occurrence.

The problem, as Professor Morgan points out, is that literal application of the absolute prohibition of Rule 1.7(a) can in many instances deprive a litigant of counsel of her choice, in circumstances where the "other" client of the firm will not be harmed by the representation, but refuses to consent for tactical reasons. So far, Professor Morgan and I are in complete agreement.

Professor Lawry, in his article entitled *The Meaning of Loyalty*, explores the concept of loyalty in the Twentieth Century Rules.²³⁵ After a careful analysis of the rules and relevant authorities, Professor Lawry concludes that in a narrow sense loyalty must be independence of judgment, not an emotional commitment of the lawyer to his client.²³⁶ He also concludes that the real basis for the rule precluding simultaneous representation of clients where one is suing the other is the concern of confidentiality.²³⁷

Professor Lawry begins his article by quoting Professor Charles Wolfram to the effect that "[t]he principle of loyalty of lawyer to client is a basic tenet of the Anglo-American conception of the lawyer-client relationship."²³⁸ He also quotes Professor Kaufman who puzzles over the meaning of the duty of loyalty: "What we mean when we say a lawyer owes a 'duty of loyalty' to a client is at the core of our notion of what kind of adversary system we have. *There is no obvious answer.*"²³⁹

Brian J. Redding, *Suing a Current Client: A Response to Professor Morgan*, ALAS LOSS PREVENTION J., Sept. 1996, at 2, 2. Mr. Redding criticizes Professor Morgan's solution, however.

Professor Morgan suggests, as a solution to these problems, a revised analysis of the prohibition on representation directly adverse to a current client. He suggests that if the client being sued will suffer significant harm to its legitimate expectations as a client, then (and only then) should the law firm be prohibited from suing it. Those expectations are the "lawyer's sense of mission" and the "client's perception of loyalty." Examples of such situations would include cases where the firm had confidential information from a client that could potentially be relevant to the case it was bringing against that client, or cases where a material adverse effect on the client would result, for example, because allegations of fraudulent or criminal conduct were involved, or the stakes were very high (e.g., the "bet the company" case). Thus, in substance, Professor Morgan suggests a sort of rule of reason analysis so that suing a current client would be prohibited in big money or potentially "messy" cases, but not in routine ones. On its face, this seems like a sensible solution to the persistent conflicts problems many large law firms face on a daily basis. In my view, however, there are problems with this approach.

Id. at 3.

Mr. Redding is not optimistic that the courts will interpret Rule 1.7(a) as Professor Morgan urges or that Rule 1.7(a) will be changed in the foreseeable future. Therefore, Mr. Redding suggests a different approach: Dealing with the collateral issues such as "1) who is a current client; 2) what does 'directly adverse' mean; 3) what is valid consent; and 4) when does a technical violation of a rule require disqualification, or other judicial sanctions." *Id.* at 4.

235. Robert P. Lawry, *The Meaning of Loyalty*, 19 CAP. U. L. REV. 1089 (1990).

236. *Id.* at 1113.

237. *Id.* at 1115.

238. *Id.* at 1089 (quoting CHARLES W. WOLFRAM, MODERN LEGAL ETHICS § 7.1.3, at 316 (1986)).

239. *Id.* at 1089 (quoting ANDREW L. KAUFMAN, PROBLEMS IN PROFESSIONAL RESPONSIBILITY 38 (3d ed. 1989)).

As one might observe of the current draft of the *Restatement*, Professor Lawry observes of the Twentieth Century Rules that “the concept [of loyalty] is not defined or explicated” and

the concept is almost exclusively utilized in the setting of discussions about conflicts of interests. It is referred to in those settings as if the concept itself were clear, and difficulties only arise when an issue of divided or conflicting loyalties is present. My premise is that the concept is not clear at all. When the conflict of interest issues arise, the use of the principle of loyalty is problematic because we really do not have a firm grasp on the concept itself. The problem is not dissimilar (and is actually related) to that of giving conceptual clarity to the infamous phrase “appearance of impropriety.” As Charles Wolfram said: “Use of the phrase [appearance of impropriety] in decisions has both obscured the process by which courts formulate their decisions and, in some instances, has lead [sic] to seriously erroneous results.”²⁴⁰

After reviewing the 1908 Canons and the 1969 Code as amended in 1974, Professor Lawry concludes with a discussion of the 1964 *Grievance Committee of the Bar v. Rottner*²⁴¹ case.²⁴² In *Rottner*, a law firm sued a client that it had represented in an unrelated matter.²⁴³ The law firm vigorously defended the propriety of this action in a disciplinary hearing. The *Rottner* court concluded that the historic traditions of the bar, captured in the concept of loyalty to the client, precluded such activity.²⁴⁴ A client “is entitled to feel that, until the business is finally disposed of in some manner, he has the undivided loyalty of the one upon whom he looks as his advocate and his champion.”²⁴⁵

Professor Lawry is critical of the emotional component of loyalty in the *Rottner* decision. He finds this to be “the source of the conceptual confusion.”²⁴⁶ “The *Rottner* case lends support to the idea that ‘loyalty’

240. *Id.* at 1089-90 (quoting CHARLES W. WOLFRAM, MODERN LEGAL ETHICS § 7.1.4, at 319 (1986)).

241. 203 A.2d 82 (1964).

242. Lawry, *supra* note 235, at 1094-99.

243. *Rottner*, 203 A.2d at 83.

244. *Id.* at 84.

245. *Id.*

246. Lawry, *supra* note 235, at 1096. Similarly, Professor Moore also criticizes the Model Code for its failure to “clearly articulate the distinction between . . . loyalty and independent professional judgment . . . [T]he essence of loyalty is emotional commitment, while the essence of independent professional judgment is intellectual detachment. Unfortunately, it is typical of lawyers to focus almost entirely on loyalty in determining the presence of a conflict of interest.” Nancy J. Moore, *Conflicts of Interest in the Simultaneous Representation of Multiple Clients: A Proposed Solution to the Current Confusion and Controversy*, 61 TEX. L. REV. 211, 217-218 (1982). She goes on to add that “the danger of this exclusive focus on loyalty is that it ignores the

means something different from 'independent professional judgment.' It also, of course, emphatically supports the proposition that loyalty entails some 'emotional' component, with the emphasis on the client's feelings of betrayal."²⁴⁷ Professor Lawry also states that regardless of what the rule was prior to *Rottner*, "the tradition of not suing a present client seems firmly entrenched today."²⁴⁸

Professor Lawry finds troubling the relationship between deference and loyalty and states that "[t]he focus cannot simply be on the client's subjective feeling."²⁴⁹ In support he references the propriety of lawyers "represent[ing] a wide range of people with varying views"²⁵⁰ and "simultaneously tak[ing] diametrically opposed positions on the same legal issue for separate clients."²⁵¹ As far as the treatment of loyalty by the Model Rules, Professor Lawry concludes that the loyalty issue is not eliminated by the language, but that the lawyer's independent professional judgment and the subjective feelings of the client are emphasized.

Moreover, Rule 1.7(b) also states that the lawyer may not represent a client if the representation is "materially limited by the lawyer's responsibility to another client or to a third person, or by the lawyer's own interests." The corresponding comments focus on the lawyer's "independent professional judgment." Interestingly, Geoffrey Hazard, principal draftsman of the 1983 Rules, stated that legal issues conflicts

potential contribution of a lawyer's knowledge, experience and objectivity—his independent professional judgment—in helping the client determine where his best interests lie." *Id.* at 218. Professor Moore goes on to give an interesting example of the danger; this example seems relevant in the bankruptcy context as well:

One common example of this danger is the apparently widespread belief that no present conflict exists between spouses who have already agreed on the settlement terms in an uncontested, no-fault divorce. Obviously, a lawyer contemplating multiple representation in such a case will feel no immediate conflict of loyalties, because an act furthering the clients' agreement is in accordance with both of their present wishes. Nevertheless, his ability to render independent professional judgment on behalf of each is immediately affected. Already he is unable to even consider recommending many alternatives theoretically available to each client; for instance, he cannot pursue a more favorable property settlement or custody agreement for either one, but rather is forced to give each a much narrower range of legal advice. Whether or not the client is permitted to consent to such narrow advice, the immediate impairment of the lawyer's independent professional judgment is certainly a factor which ought to be recognized by the lawyer and explained to the client.

Id. at 218-19.

247. Lawry, *supra* note 235, at 1096.

248. *Id.* at 1096 n.32. Professor Lawry cites in support of this statement comment 3 to Rule 1.7 of the Model Rules.

249. *Id.* at 1097.

250. *Id.*

251. *Id.*

"implicate" Rule 1.7(b) and the loyalty concept. Even though the language of the Rule speaks to "the lawyer's responsibility to another client," Hazard claims that arguing for a narrowing of the "holder in due course" rule for a debtor against a bank which is not a client is not permitted without the consent of the lawyer's several bank clients. Hazard concedes this requirement gives each of the bank clients "a veto over the lawyer's choice of new clients" because Rule 1.7(b) requires informed consent if the operative language, "the lawyer's responsibilities to another client," is transgressed. He argues that this particular legal issue conflict is a transgression.²⁵²

Professor Lawry asserts that Professor Hazard's view is sound

only if the lawyer may do nothing to "harm" a client's interests while representing that client, including arguing a legal point which the client would not want argued that way, even if the lawyer is not representing the client with respect to that issue. On those grounds, however, all legal issues conflicts would be subject to the first client's veto power. More importantly, all issues which the first client would perceive as harmful would have to be argued his or her way. This cannot be right.²⁵³

After completing his analysis of the Twentieth Century Rules, Professor Lawry tries to bring clarity to the subject and justify the rule precluding simultaneous representation in unrelated cases. First, as to loyalty, he concludes that the focus must be on the lawyer and the real issue is independence of judgment; the feelings of the client are irrelevant.²⁵⁴ Second, as far as the litigation rule, Professor Lawry concludes that it can be justified as a prophylactic rule which avoids a situation where independence of judgment and confidentiality may be compromised.²⁵⁵ Nonetheless, Professor Lawry would modify the per se rule precluding simultaneous representation "in the big firm/corporate client context,"²⁵⁶ since, given that context, the traditional concept of loyalty is out of place.²⁵⁷

252. *Id.* at 1100 (footnotes omitted).

253. *Id.* at 1100-01.

254. *Id.* at 1105-06.

255. *Id.* at 1107-08.

256. *Id.* at 1108.

257. *Id.*

I have used Royce's definition of loyalty (devotion to a cause), as a working definition, tying it specifically to judgment and effort in the lawyering tradition. No matter the definition, however, the unexamined problem with the loyalty issue is that it is rooted in an image of the lawyer-client relationship that is both personal (one-on-one), and extensive ("client" is not only "interest" or "job," but one half of a real relationship like the old family doctor had with his patients with multiple encounters and a history). It also envisions a client who is vulnerable and a lawyer who must

Professor Lawry concludes that “[a]bsent consent and good rules, the firm should not be allowed to represent two clients simultaneously if one is suing the other. The reason is not loyalty, but concern about confidentiality.”²⁵⁸ Professor Lawry concludes that “[t]he *IBM* kind of problem is actually better handled by ‘limited engagement representations.’”²⁵⁹

Chapter 8 of the *Restatement* dilutes the duty of loyalty in that, with the exception of parties aligned in opposition in civil litigation, one can be adverse to an existing client if there is not a substantial risk that the representation would be materially and adversely affected by the duties to another current client, one of which duties is the duty of loyalty. This is the approach urged

pay extreme deference to such a client as the act of the strong toward the weak. Of course it also means the lawyer must sacrifice fees to ensure that the fragile client’s feelings are not hurt.

Id. at 1112.

258. *Id.* at 1115.

259. *Id.* In an interesting postscript, Professor Jean Mortland, queries whether “we sometimes turn the conflict-of-interest rules into full-employment-for-lawyers rules.” Jean A. Mortland, *The Meaning of Loyalty—The Other Side of the Coin*, 19 CAP. U. L. REV. 1117, 1117 (1990). To illustrate her point, she discusses an accident case where the owner and driver of the automobile and his two guests sued a bus company whose bus had collided with the car. The bus company joined the owner and driver as an additional defendant. The same lawyer represented all three and a verdict was rendered against the bus company and the owner and driver. The trial court set the judgment aside because of a conflict of interest and the owner-driver and the two guests appealed. *Id.* Professor Mortland rather persuasively argues that what appears to be an obvious conflict was not.

Canon 6 of the 1908 Code states that “a lawyer represents conflicting interests when, in behalf of one client, it is his duty to contend for that which duty to another client requires him to oppose.” The majority here considered that the lawyer had a duty to present a case against the individual defendant on behalf of the other two plaintiffs and to defend that case for the individual defendant. Clearly that would be within the prohibition of Canon 6. However, if my analysis is correct, that was not the lawyer’s duty. It was simply to present the case for all three against the bus company and probably to defend the case against the individual defendant. That would not violate Canon 6.

The 1969 Code prohibits a lawyer from continuing multiple employment if her independent professional judgment is likely to be affected. Again, if my analysis is correct, the lawyer’s independent professional judgment would not be affected in this case. The 1974 amendment requires withdrawal if the situation “would be likely to involve him in representing differing interests,” and defines “differing interests” as “every interest that will adversely affect either the judgment or the loyalty of a lawyer to the client.” The lawyer in my case would not be representing differing interests, although differing interests would be present.

The 1983 Model Rules prohibit representation of one client “if the representation of that client will be directly adverse to another client.” Representation of the two plaintiffs would be directly adverse to representation of the plaintiff-defendant if the two plaintiffs were asserting an action against the plaintiff-defendant. If they were not, it would not be directly adverse, if adverse at all.

Id. at 1119-20 (footnotes omitted).

by most bankruptcy lawyers. The question remains, however, whether this rule or the absolute bar of the civil litigation rule applies to the bankruptcy case as a whole.

III. CONFLICTS IN WORKOUTS AND REORGANIZATION CASES IDENTIFIED AND ANALYZED

The following discussion of issues frequently arising in workouts and bankruptcy reorganization cases assumes that the consent of the client in the unrelated matter has not been obtained. That consent would be of limited efficacy in a bankruptcy reorganization case, but most likely would be dispositive in the context of a workout.

(1) A lawyer may represent a client notwithstanding a conflict of interest prohibited by § 201 if each affected client or former client gives informed consent to the lawyer's representation. Informed consent requires that the client or former client have reasonably adequate information about the material risks of such representation to that client or former client.

(2) Notwithstanding the informed consent of each affected client or former client, a lawyer may not represent a client if:

- (a) the representation is prohibited by law;
- (b) one client will assert a claim against the other in the same litigation; or
- (c) in the circumstances, it is not reasonably likely that the lawyer will be able to provide adequate representation to one or more of the clients.²⁶⁰

In a bankruptcy reorganization case, the court must find that counsel has no adverse interest and is therefore disinterested. Therefore, the waiver requirement does not come into play in bankruptcy reorganization cases, although the waiver most likely would avoid disqualification if an impermissible conflict existed in a workout case.

A. Representing a Debtor in a Workout When a Creditor Is a Client in an Unrelated Matter.

A lawyer regularly represents a commercial bank. The commercial bank is a lender to a company in financial difficulty. The company in financial difficulty seeks to retain the lawyer to negotiate satisfactory arrangements to avoid a bankruptcy filing. Is it ethically permissible, absent consent of the lender, for the lawyer to represent the company or is there a disqualifying

260. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 202 (Proposed Final Draft No. 1, 1996).

conflict because of the representation of the lender in unrelated matters? The answer is clear at least under the Model Code and Rules.

The lawyer regularly representing a commercial bank could not take on the representation insofar as it contemplated attempting to negotiate satisfactory arrangements with the commercial bank, absent the informed consent of both the bank and the debtor. Under the Model Code the lawyer would be representing differing interests. As defined in the Model Code, "[d]iffering interests" include every interest that will adversely affect either the judgment or the loyalty of a lawyer to a client, whether it be a conflicting, inconsistent, diverse, or other interest."²⁶¹ Negotiating with the banker client on behalf of the debtor client "would be likely to involve [the lawyer] in representing differing interests"²⁶² precluded by DR 5-105(A). Absent consent, the representation also would be impermissible under Model Rule 1.7(a) since "the representation of [the debtor] client will be directly adverse to [the bank] client."²⁶³ These are clear cut, easy to understand rules and the outcome is certain.

In contrast, section 201 of the *Restatement* focuses on the impact of the lender relationship on the representation of the debtor. If there is a substantial risk that representation of the debtor would be materially and adversely affected because of the lender relationship, the representation is impermissible absent the consent of both lender and debtor. The result should be the same, but it is not as clear cut as under the Model Code and Rules. The key is whether the effectiveness of the representation of the debtor will be impaired because of the duty of loyalty to the lender. Using that approach, the representation may be permissible depending on the facts. If, by way of example, the lawyer asked to represent the company works for a large law firm with offices around the country and the lawyer representing the lender is in another city and does not even know the lawyer who will represent the company or the company's management or ownership, it is hard to imagine how the representation of the debtor could be adversely affected.

It is not uncommon for a lender to reach agreement in principle with the debtor and strongly recommend that the debtor use counsel acceptable to the lender. Such counsel will often have a longstanding relationship with the lender and not only represent the lender from time to time but also have one or more open matters for the lender. So long as these relationships are fully disclosed and the implications adequately laid out, and counsel believes that it can adequately represent the debtor and the debtor and the lender consent, the representation is permissible under the ABA Code and Rules. That would clearly be so under both the Model Code and the Model Rules so long as, in

261. ANNOTATED CODE OF PROFESSIONAL RESPONSIBILITY Definition 1 (1979).

262. *Id.* at DR 5-105(A).

263. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.7(a) (1995).

the language of Disciplinary Rule 5-105(C) the lawyer "can adequately represent the interest of each and if each consents to the representation after full disclosure of the possible effect of such representation on the exercise of [the attorney's] independent professional judgment on behalf of each,"²⁶⁴ and under Rule 1.7(a), if "(1) the lawyer reasonably believes the representation will not adversely affect the relationship with the other client; and (2) each client consents after consultation."²⁶⁵ The result is similar under section 202 of the *Restatement*; such representation would be allowed if "each affected client . . . gives informed consent to the lawyer's representation,"²⁶⁶ and it is "reasonably likely that the lawyer will be able to provide adequate representation."²⁶⁷

A recent lawsuit involving an alleged breach of fiduciary duty arose out of the representation of a lender. The alleged conflict was the simultaneous representation of the lender to and an unsecured creditor of a debtor. Law firm represented regular client bank in connection with a secured loan it had made to manufacturing company.²⁶⁸ A check for conflicts under the manufacturing company's name and the name of its two owners who had guaranteed payment of the loan disclosed none.²⁶⁹ Law firm therefore represented bank in negotiating a workout with manufacturing company prebankruptcy and in connection with the Chapter 11 case subsequently filed by manufacturing company.

Several weeks after the filing of the Chapter 11, a supplier to and substantial unsecured creditor of the manufacturing company discovered that it was represented by Law Firm in unrelated matters and took the position that law firm might have a conflict of interest. Law Firm resigned from the only engagement it had open for the creditor and the creditor sued the law firm and its bank client.²⁷⁰

The undisputed facts established the following:

1. Law Firm conducted a conflict search using the names of the manufacturing company and related parties but did not request a list of unsecured creditors from the manufacturing company in order to include unsecured creditors in the conflict search and none was made under the names

264. ANNOTATED CODE OF PROFESSIONAL RESPONSIBILITY DR 5-105(C) (1979).

265. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.7(a) (1995).

266. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 202(1) (Proposed Final Draft No. 1, 1996).

267. *Id.* § 202(2)(c).

268. Leaf, Inc.'s Memorandum in Support of Its Motion for Partial Summary Judgment at 5, Leaf, Inc. v. Continental Bank N.A. (N.D. Ill. 1992) (No. 90-C-3888).

269. *Id.* at 6.

270. *Id.* at 9.

of anyone other than the manufacturing company and its two owners who had guaranteed payment of the bank loan.²⁷¹

2. The bank loan was a revolving loan which allowed the bank to go to a lock box arrangement and it did so. Thus, all payments from manufacturing account debtors were made into the lock box, the funds were used to pay down the loan and bank would reloan additional monies in its discretion.²⁷²

3. The representation of unsecured creditor by law firm was substantially limited to intellectual property matters.²⁷³

4. The unsecured creditor had been a long-term supplier to manufacturing company and ended up losing additional money by supplying manufacturing company during the 1989 Christmas season.²⁷⁴

In its preliminary statement, counsel for the unsecured creditor characterized the lawsuit as follows:

This lawsuit involves a classic conflict of interest, in which [law firm] first ignored and then knowingly breached its fiduciary and contractual duties to its small client—[unsecured creditor]—in favor of a massive client—[bank].

As [law firm's] undisputed conduct proved, no man can serve two masters, for [law firm's] legal strategies enriched [bank] with over \$900,000 in assets and proceeds that were bled from [unsecured creditor] by a scheme concocted by [bank] and masterminded by [law firm]. Once it was alerted to the conflict, [law firm] belatedly and ineffectively attempted to cure the conflict by dumping [unsecured creditor] as its client—after the damage had already been done.

In this summary judgment motion, [unsecured creditor] demonstrates that, as a matter of law, [law firm] breached the fiduciary duty and duty of good faith and fair dealing that it owed to [unsecured creditor], its client. Speaking with stern bluntness, the courts have stressed that a law firm such as [law firm] owed [unsecured creditor] a duty of “undivided loyalty” and that [law firm] could not—once the conflict became manifest—attempt to drop [unsecured creditor] “like a hot potato, especially if it is in order to keep a far more lucrative client.” No protestations by [law firm]—let alone genuine factual issues—preclude summary judgment in [unsecured creditor's] favor.²⁷⁵

Although a number of claims were asserted against law firm by unsecured creditor, one of the key claims was a breach of fiduciary duty and duty of good faith and fair dealing as a result of law firm “simultaneously [representing

271. *Id.* at 6.

272. *Id.* at 7.

273. *Id.* at 3.

274. *Id.* at 4.

275. *Id.* at 2.

bank] in a matter directly adverse to the interests of [unsecured creditor], one of its existing clients.”²⁷⁶ In a motion for summary judgment, counsel for the unsecured creditor relied on the “common law that an attorney owes the client a fiduciary duty of absolute and undivided loyalty.”²⁷⁷ In addition to the common law, the motion relied on the Code of Professional Responsibility which imposed “an absolute duty of undivided loyalty and allegiance to each client”²⁷⁸ and DR 5-105 which “specifically prohibits an attorney from simultaneously representing two clients with adverse interests.”²⁷⁹

Counsel for the unsecured creditor submitted an affidavit of Professor Stephen Gillers of New York University.²⁸⁰ Professor Gillers had taught Regulation of Lawyers and Professional Responsibility at New York University School of Law since 1978. He had also taught the course as a visiting professor at Harvard Law School and Cardozo Law School.²⁸¹

In his affidavit, Professor Gillers stated the following relevant opinions:

19. Accordingly, it is my opinion that at the time [law firm] took on representation of [bank] and at the time [law firm] appeared on behalf of [bank] in the Superior bankruptcy action, [unsecured creditor] was one of [law firm’s] present clients.

20. It is my opinion that as one of [law firm’s] present clients, [law firm] owed [unsecured creditor] a fiduciary duty of absolute and undivided loyalty.

21. It is my opinion that the fiduciary duty of absolute and undivided loyalty that [law firm] owed [unsecured creditor] encompassed a duty to avoid all conflicts of interest with [unsecured creditor].

22. It is my opinion that, by concurrently representing [unsecured creditor] and [bank], an entity whose interests were directly adverse to [unsecured creditor’s] regarding the limited pool of Superior assets available to its creditors—even as [law firm] was advising [bank] on how to position itself to obtain a preferred claim to this limited pool, and even as [unsecured creditor] was providing Superior with product that would enlarge the pool *directly* to [bank’s] benefit and [unsecured creditor’s] loss—[law firm] represented an interest directly adverse to [unsecured creditor].

23. It is my opinion that, by taking on the [bank] representation and appearing on behalf of [bank] in the Superior bankruptcy action

276. *Id.* at 10.

277. *Id.* at 11.

278. *Id.* at 12.

279. *Id.* at 12-13.

280. Affidavit of Stephen Gillers, submitted by Leaf, Inc. in Support of Its Motion for Partial Summary Judgment, *Leaf, Inc. v. Continental Bank N.A.* (N.D. Ill. 1992) (No. 90-C-3888).

281. *Id.* at 1-2.

without ever seeking consent from [unsecured creditor], [law firm] breached its fiduciary duty to [unsecured creditor].

24. My opinions obtain under the applicable provisions of each of the Rules of Professional Conduct for the Northern District of Illinois, the ABA Code of Professional Responsibility, and the Illinois Code of Professional Responsibility.²⁸²

Counsel for Law Firm disagreed. First, although conceding that there is a duty of loyalty, it was argued that “[t]he duty of *undivided* loyalty with regard to a matter is not an *unlimited* duty as to all matters.”²⁸³ Instead, consistent with the agency rule, “the scope of an agent’s duty to its principal . . . is defined by, and limited to, matters connected with the agency.”²⁸⁴ Therefore, since law firm had undertaken no work related to the unsecured creditor’s involvement with the manufacturing company, no fiduciary duty was owed to the unsecured creditor relating to its dealings with the manufacturing company. In essence, law firm asserted that the duty of loyalty was measured by the scope of the representation and was not “an unlimited duty as to all matters.”²⁸⁵ Second, the law firm argued that the applicable ethical rule was narrower than the Model Code in that it provided that “[a] lawyer shall decline proffered employment if the exercise through his independent professional judgment in behalf of a client will be or is likely to be adversely affected by the acceptance of the proffered employment.”²⁸⁶ In contrast, the Model Code provided that “a lawyer should not undertake a representation ‘if it would be likely to involve him in representing differing interests.’”²⁸⁷

Two clients rarely have interests that are entirely identical. If a strict concept of differing interests were employed, a lawyer might also never be able to represent two clients without explicit client consent.²⁸⁸ The unsecured creditor did not claim that the law firm’s judgment on its behalf was actually or potentially impaired as a result of the representation of the bank; indeed, the law firm’s lawyers working for the unsecured creditor on the unrelated matters were not even aware of the bank representation as to the particular matter.

282. *Id.* at 7-8.

283. Memorandum of Law Firm in Support of Its Cross-Motion for Summary Judgment and in Opposition to Leaf’s Motion for Partial Summary Judgment at 10, *Leaf, Inc. v. Continental Bank N.A.* (N.D. Ill. Mar. 6, 1992) (No. 90-C-3888).

284. *Id.* “[A]n agent ‘is not . . . necessarily prevented from acting in good faith outside his employment in a matter which injuriously affects his principal’s business.’” *Id.* at 10 n.11 (citing RESTATEMENT (SECOND) OF AGENCY § 387 cmt. b).

285. Memorandum of Law Firm in Support of Its Cross-Motion for Summary Judgment and in Opposition to Leaf’s Motion for Partial Summary Judgment at 10, *Leaf, Inc. v. Continental Bank N.A.* (N.D. Ill. Mar. 6, 1992) (No. 90-C-3888).

286. *Id.* at 12-13.

287. *Id.* at 13.

288. *Id.* at 14 n.19.

1997] CONFLICTS OF INTEREST IN WORKOUTS AND REORGANIZATIONS 857

Counsel for the law firm characterized the rule asserted by the unsecured creditor as one that would impose civil liability on a lawyer if it assisted one client in a course of action that adversely affected the economic interests of another client for which it had wholly unrelated duties.²⁸⁹

The brief went on to point out that all but two of the cases:

involved the question of disqualification of an attorney where one client of the attorney was litigating against another client of that attorney. Once two clients sue each other, courts have been reluctant to allow an attorney to *continue to represent* either *in the litigation*, because it is difficult for the attorney to demonstrate that his or her professional judgment will not be impaired by divided loyalty in the *future* conduct of the case.²⁹⁰

How can one reconcile the opinion of Professor Gillers and the position articulated by counsel for Law Firm? Is Professor Gillers correct that the Law Firm had in general "a fiduciary duty of absolute and undivided loyalty,"²⁹¹ as distinguished from a duty of loyalty as to the particular matter or matters involved in the representation? Does representation on one or several matters create an "undivided loyalty that . . . encompass[s] a duty to avoid all conflicts of interest?"²⁹² Was the taking on of the representation of the bank and appearing on behalf of the bank in the bankruptcy without seeking consent from the unsecured creditor a breach of the fiduciary duty to the unsecured creditor, regardless of the lack of knowledge that the other client was a creditor

289. *Id.* at 14. Counsel for the law firm asserted that there were only a handful of cases even addressing the far-fetched theory asserted by counsel for the unsecured creditor and that those involving the matter rejected such a liability.

In *Carlson v. Fredrikson & Byron, P.A.*, 475 N.W.2d 882 (Minn. App. 1991), the court affirmed summary judgment against a fiduciary duty claim by a client against his attorney, where the client claimed the attorney had worked for other clients whose interests were adverse to the plaintiff's. Examining the claim under Minnesota's professional ethics standards, the court held that a law firm has no duty to inform a client about its representation of another client if there is no substantial, relevant relationship between the two representations.

Similarly, in *Steinbach v. Meyer*, 412 N.W.2d 917 (Iowa App. 1987), a law firm represented a farmer at the same time that one of its partners voted (in his capacity as a member of a bank's board of directors) to terminate the farmer's credit. In affirming summary judgment, the court found that the firm had not breached its fiduciary duty to the farmer, because the farmer had never sought legal advice from the firm concerning the loans. The firm therefore owed him no duty with respect to those loans.

Id. at 15.

290. *Id.* at 16.

291. Affidavit of Stephen Gillers, submitted by Leaf, Inc. in Support of Its Motion for Partial Summary Judgment at 7, *Leaf, Inc. v. Continental Bank N.A.* (N.D. Ill. 1992) (No. 90-C-3888).

292. *Id.*

of the manufacturing company? If so, would the result be different under the *Restatement*?

Under section 201 of the *Restatement* “[a] conflict of interest is involved if there is a substantial risk that the lawyer’s representation of the client would be materially and adversely affected by the lawyer’s own interests or by the lawyer’s duties to another current client, a former client, or a third person.”²⁹³ This does not answer the question and it depends on the duty of loyalty to the client in the unrelated matter. Comment b to the *Restatement* suggests that the duty of loyalty is not absolute, and it will depend on the circumstances as to whether it precludes representation adverse to another client.

b. Rationale. The prohibition against lawyer conflicts of interest reflects several competing concerns. First, the law seeks to assure clients that their lawyers will represent them with undivided loyalty. A client is entitled to be represented by a lawyer whom the client can trust. Instilling such confidence is an objective important in itself. For example, the principle underlying the prohibition against a lawyer’s filing suit against a present client in an unrelated matter (see § 209, Comment *e*) may also extend to situations, not involving litigation, in which significant impairment of a client’s expectation of the lawyer’s loyalty would be similarly likely. Contentious dealings, for example, involving charges of bad faith against the client whom the lawyer represents in another matter would raise such a concern. So also would negotiating on behalf of one client when a large proportion of the lawyer’s other client’s net worth is at risk.²⁹⁴

B. Representing a Debtor in a Workout When a Creditor Is a Former Client.

If we assume that a lawyer represented a commercial bank on a one-time basis in documenting a loan between the bank and its debtor, the bank is a former client. Does the prior representation preclude the lawyer from representing the debtor of the bank in a workout with the bank? The Canons precluded representation adversely affecting an interest of a client with respect to which confidence was reposed.²⁹⁵ The Model Code does not have a specific rule, but such representation is precluded if there were a potential for a breach of confidence under Canon 4 or an appearance of impropriety under Canon 9. The Arizona Supreme Court has interpreted the Model Code to

293. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 201 (Proposed Final Draft No. 1, 1996).

294. *Id.* § 201 cmt. b.

295. CANONS OF PROFESSIONAL ETHICS Canon 6 (1908).

preclude representation of the borrower in initiating a bankruptcy case.²⁹⁶ Would the result be the same as to a prepetition workout? The Model Rules preclude representation adverse to a former client if the same or a substantially related matter is involved and the new client's interests are materially adverse to the interests of the former client.²⁹⁷ Representation of the borrower might also be precluded for the additional reason that information obtained from the prior representation of the lender might be involved. However, assuming no information from the earlier representation is involved, it is not clear under the Model Rules that the representation is precluded since the new representation would involve rewriting the loan, not an attack on the original documentation. The test and the uncertainty are the same under section 213 of the *Restatement* which precludes the representation if the new matter involves the work performed for the former client or there is a substantial risk that the representation of the new client would involve the use of confidential information.²⁹⁸

296. *In re Breen*, 830 P.2d 462 (Ariz. 1992).

297. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.9(a) (1995).

(a) A lawyer who has formerly represented a client in a matter shall not thereafter represent another person in the same or a substantially related matter in which that person's interests are materially adverse to the interests of the former client unless the former client consents after consultation.

Id. at Rule 1.9(a). The balance of Rule 1.9 is as follows:

(b) A lawyer shall not knowingly represent a person in the same or a substantially related matter in which a firm with which the lawyer formerly was associated had previously represented a client

(1) whose interests are materially adverse to that person; and

(2) about whom the lawyer had acquired information protected by Rules 1.6 and 1.9(c) that is material to the matter; unless the former client consents after consultation.

(c) A lawyer who has formerly represented a client in a matter or whose present or former firm has formerly represented a client in a matter shall not thereafter:

(1) use information relating to the representation to the disadvantage of the former client except as Rule 1.6 or Rule 3.3 would permit or require with respect to a client, or when the information has become generally known; or

(2) reveal information relating to the representation except as Rule 1.6 or Rule 3.3 would permit or require with respect to a client.

Id. at Rule 1.9(b)-(c).

298. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 213 (Proposed Final Draft No. 1, 1996).

Unless both the affected present and former clients consent to the representation under the limitations and conditions provided in § 202, a lawyer who has represented a client in a matter may not thereafter represent another client in the same or a substantially related matter in which the interests of the former client are materially adverse. The current matter is substantially related to the earlier matter if:

(1) the current matter involves the work the lawyer performed for the former client; or

C. Representing the Debtor or Creditors in Initiating a Chapter 11 Case When the Lawyer Represents or Represented a Creditor in an Unrelated Matter.

Can a lawyer who represents a lender, trade creditor, stockholder or partner, or a party having a contractual relationship with a debtor, initiate a voluntary bankruptcy case on behalf of the debtor? Since all parties in interest are affected by the filing of the bankruptcy petition, disciplinary authorities and the courts may very well conclude that there is a per se disqualification from filing a voluntary petition if other parties in interest are represented by the lawyer. That appears to be the holding of the Arizona Supreme Court in *In re Neville*.²⁹⁹ In that case, Neville, a lawyer admitted to practice in Arizona, was charged with several violations of the Arizona Rules of Professional Conduct. The rules in force at the time were based on the Model Code. One of the charges was a violation of Disciplinary Rule 5-105(A)³⁰⁰ which requires a lawyer to decline employment "if the exercise of his independent professional judgment in behalf of a client will be or is likely to be adversely affected by the acceptance of the proffered employment."³⁰¹

Neville had represented Bly in a sale of property from Bly to Cummings. The deferred balance of the purchase price was secured by the property sold. There was a default and Bly, through another attorney, foreclosed and obtained a deficiency judgment in excess of \$60,000 against Cummings.³⁰² Neville had represented Cummings on other matters, was trusted by Cummings, and Cummings prevailed upon Neville to represent him in a Chapter 7 bankruptcy case.³⁰³ The Supreme Court found that there was a violation of Disciplinary Rule 5-105. "As an unsecured judgment creditor, Bly had adverse interests to Cummings at the time of filing."³⁰⁴ But that is not determinative.

(2) there is a substantial risk that representation of the present client will involve the use of information acquired in the course of representing the former client, unless that information has become generally known.

Id. Comment *d* sets forth the types of former client conflicts which are prohibited. *Id.* § 213 cmt. d.

299. 708 P.2d 1297 (Ariz. 1985) (en banc).

300. *Id.* at 1305.

301. ANNOTATED CODE OF PROFESSIONAL RESPONSIBILITY DR 5-105(A) (1979).

302. *Neville*, 708 P.2d 1300.

303. *Id.* at 1305. Neville telephoned Bly and asked him to consent to Neville representing Cummings in his bankruptcy case. "Bly gave his consent, but did so 'reluctantly' after being 'pressed' by [Neville] who said that if Bly didn't consent he wouldn't handle the matter but another attorney certainly would." *Id.* The Supreme Court agreed with the disciplinary committee that there was not a knowing and voluntary consent. *Id.* at 1306. At the time, there was no requirement in the Model Code that the consent be in writing and no written consent was obtained. In 1985 the Supreme Court of Arizona abandoned the Model Code and adopted the Model Rules, which required a writing to achieve full consent under Rule 1.8.

304. *Id.* at 1305-06.

Disciplinary Rule 5-105(A) requires a finding that “the exercise of [Neville’s] independent professional judgment in behalf of a client will be or is likely to be adversely affected by the acceptance of the proffered employment,”³⁰⁵ or that it would be likely to involve him in representing different interests.³⁰⁶

Because Neville was representing only Cummings in the bankruptcy case, the independent professional judgment of Neville in his representation of Bly could not be adversely affected by the representation of Cummings. Furthermore, in a Chapter 7 liquidation case, it is up to the trustee to object to and litigate claims or sue to set aside prepetition transfers. Thus, there was no action postpetition required of Neville that might be directed at Bly which could be adversely affected or be likely to involve Neville in representing different interests. The case did not involve a possible objection to discharge or the dischargeability of Bly’s claim against Cummings.

Unlike Disciplinary Rule 105(A), Model Rule 1.7(a) better supports the Arizona court’s ruling. Rule 1.7(a) precludes representation directly adverse to a client unless “(1) the lawyer reasonably believes the representation will not adversely affect the relationship with the other client; and (2) each client consents after consultation.”³⁰⁷ According to comment 3 to Model Rule 1.7, the rule is based on the duty of loyalty which “prohibits undertaking representation directly adverse to [a] client without that client’s consent.”³⁰⁸

In *In re Breen*,³⁰⁹ the Arizona Supreme Court agreed with the disciplinary committee and imposed a two-year suspension for several violations of the Model Code. Breen had represented clients in negotiating a loan to Macy. The loan was secured by a deed of trust on thirteen acres of property. Macy defaulted and the clients, represented by other counsel, commenced foreclosure proceedings. Nine days before the scheduled trustee’s sale of the Macy property, Breen filed a Chapter 11 case on behalf of Macy to prevent the sale.³¹⁰ The Supreme Court characterized this as “an action directly adverse to his former clients.”³¹¹ Breen had neither informed the prior clients of his intent to represent Macy nor obtained their consent.³¹² The Court upheld the Committee’s conclusion that Breen violated Disciplinary Rule 5-105(A) by filing the Chapter 11 case on behalf of Macy. The court did not distinguish the former client situation in *Breen* from the present client situation in *Neville*. Model Rule 1.9 may require a different holding because it would preclude the filing by the former attorney only if the bankruptcy case

305. ANNOTATED CODE OF PROFESSIONAL RESPONSIBILITY DR 5-105(A) (1979).

306. *Id.*

307. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.7(a) (1995).

308. *Id.* at Rule 1.7 cmt. 3.

309. 830 P.2d 462 (Ariz. 1992).

310. *Id.* at 464.

311. *Id.*

312. *Id.*

were substantially related to the loan transaction giving rise to the claim against the debtor and the Chapter 11 debtor's interests were materially adverse to the interests of the former client.

Under the *Restatement*, assuming that the initiation of a voluntary bankruptcy case is not considered the assertion of a claim resulting in a per se disqualification under section 209(2),³¹³ the propriety of the representation will depend on the circumstances. If under section 201 the lawyer's representation of the debtor in initiating the bankruptcy case would be materially and adversely affected by the lawyer's duties to the other parties-in-interest who are current clients of the lawyer, then the representation would be impermissible. However, it is hard to see how the filing of a voluntary petition could be materially and adversely affected, although defending against a motion to dismiss the voluntary petition as one filed in bad faith is another matter and could result in disqualification under both section 209(2) and section 201 if the debtor's relationships with clients on unrelated matters might be relevant to the issue of bad faith.

There is a clear distinction between the initiation of voluntary and involuntary cases. A voluntary petition does not assert a claim against anyone although it does have consequences for parties in interest. It can, of course, be viewed as seeking relief against creditors and, depending on the circumstances of each case, other parties in interest, by bringing into effect the provisions of the Code, e.g., § 362 (stay), § 365 (executory contracts) and § 1129(b) (cramdown). In contrast, an involuntary petition directly and immediately asserts a claim or seeks relief against the debtor under the Bankruptcy Code.

The initiation of a bankruptcy case has consequences for parties to unperformed contracts with the debtor and creditors of the debtor. Therefore, if the commencement of the case is the commencement of civil litigation within the meaning of section 209(2), a lawyer could not, absent consent, represent a debtor or a trustee if the lawyer represents a creditor of the debtor or a person who has an unperformed contract with the debtor.

A complicating factor is that at the time of the initiation of an involuntary case, counsel may not be in a position to identify all parties in interest. Checking conflicts under the name of the debtor will not disclose the names of clients in unrelated matters who will be parties in interest in the bankruptcy case. However, once counsel is aware of a party in interest represented in an unrelated matter or is in a position to determine who are the parties in interest, absent appropriate consent, counsel should not initiate a bankruptcy case or continue as counsel in an involuntary case if § 209(2) applies or section 201 requires it.

313. *Infra*, Part III(D) and Part IV.

D. Representing a Debtor-In-Possession or Trustee When a Party-In-Interest Is a Client in an Unrelated Matter.

In determining whether a lawyer can represent a debtor-in-possession or a trustee, the Bankruptcy Code requires that the lawyer be disinterested and not hold or represent an interest adverse to the estate. A basic issue which must be determined by the court is whether the lawyer has a conflict because of the representation of a party in interest in unrelated matters. The Bankruptcy Code makes it clear that there is no per se disqualification because of the representation of a creditor, but it does not address other representational interests. Assuming there is no per se disqualification, the issue for the Bankruptcy Court as to creditors and other parties in interest, should be whether the representation of the client in the unrelated matter will limit or otherwise adversely affect the proposed representation. If so, there is an adverse interest which precludes employment.

The issue of whether representation of creditors in unrelated matters is disqualifying arose in the *Revco* cases.³¹⁴ The author was appointed as examiner and the Noteholder's Committee objected to the appointment on several grounds, including that the representation of three trade creditors and two noteholders on unrelated matters was a disqualifying conflict. On behalf of the Noteholder's Committee, Fried, Frank, Harris, Shriver & Jacobson ("Fried Frank") asserted that the author could not meet the disinterested standard.³¹⁵ "Mr. Smith's firm represents: (1) two members of the Unofficial Committee of Secured Bank Lenders (the "Bank Committee"); (2) three members of the Official Committee of Unsecured Trade Creditors (the "Trade Committee")—including its Chair."³¹⁶ "Mr. Smith could not meet the 'disinterested person' requirement of section 101(13). First, Mr. Smith's firm's representation of members of two creditor groups, with interests adverse to each other, and with each adverse to other creditor groups is a classic illustration of an inability to meet section 101(13)(E)'s requirement."³¹⁷

Fried Frank also asserted that the author's employment as examiner was precluded by Model Code Disciplinary Rule 5-105(A) and by Ethical Consideration 9-6 which precludes any appearance of impropriety.

314. *In re Revco, D.S. Inc.* (Bankr. N.D. Ohio 1990) (Nos. 588-1308 through 588-1321, 588-1305, 588-1761 through 588-1812, and 588-1820).

315. Response of Official Committee of Unsecured Noteholders in Opposition to Application of United States Trustee for Order Appointing Gerald K. Smith, Esq. as Examiner, *In re Revco D.S., Inc.* (Bankr. N.D. Ohio May 17, 1990) (Nos. 588-1308 through 588-1321, 588-1305, 588-1761 through 588-1812, and 588-1820).

316. *Id.* at 2.

317. *Id.* at 16.

In addition to the rules concerning disinterestedness that are set forth in section 101(13) of the Bankruptcy Code, the Code of Professional Responsibility as adopted by the Supreme Court of Ohio (the "CPR") also precludes the acceptance of proffered employment when one has conflicting interests. Toward this end, Disciplinary Rule 5-105 ("DR 5-105") of the CPR provides as follows: (A) A lawyer shall decline proffered employment if the exercise of his independent professional judgment in behalf of a client will be or is likely to be adversely affected by the acceptance of the proffered employment, except to the extent permitted under DR-5-105(C). If Mr. Smith were to accept employment as examiner in this case, the spirit, if not the letter, of DR 5-105 would plainly be violated.³¹⁸

That at least the appearance of impropriety would be present here is clear. Mr. Smith's firm represents the Two Bank Creditors, potential *targets* of the investigation that Mr. Smith has been appointed to undertake. His firm also represents the Three Trade Committee Members, potential *beneficiaries* of such investigation. And though any Revco investigation would address the desirability of commencing LBO-related fraudulent conveyance litigation, Mr. Smith is personally prosecuting exactly such an action. Taken together, these facts demonstrate conclusively apparent, if not actual, professional improprieties that would mandate the disapproval of Mr. Smith's appointment in this case.³¹⁹

The author's response was authored by Ms. Freeman and Mr. John P. Frank³²⁰ It strongly disagreed.

Lewis and Roca represents both trade creditors and bank lenders to Revco on unrelated matters. The firm's representation of those clients is not large, but all clients are valued and important.

....

Essentially, the parties filing objections to Mr. Smith's appointment as an examiner claim that he may advocate for pursuit of LBO claims because that would benefit his firm's clients. They overlook the fact that it would benefit the trade creditors only if his judgment proved right. If Mr. Smith opined there were valid causes of action to be pursued when they could not be proved, the estate would be drained of money otherwise available to pay creditors, by administrative attorneys' fees on a large scale. Concerns for any creditors could only serve as an impetus for even more careful analysis.

Moreover, in a case this large, virtually every attorney qualified to serve as an examiner will likely have firm attorneys representing at least one creditor on unrelated matters. Such representation cannot and does not

318. *Id.* at 22-23.

319. *Id.* at 25-26.

320. Mr. Frank, one of Mr. Smith's partners, is an author of 28 U.S.C. § 455 and appeared at all hearings on it.

disqualify an attorney from examining matters where those creditors are not even potential parties.

....

We recognize that firm clients who are potential targets of causes of action to be analyzed must waive any conflict arising from that analysis, or Mr. Smith cannot serve as examiner. When asked for waivers, with an explanation of the potential consequences, the waivers were given. Two were later withdrawn, and for that reason the firm has withdrawn.³²¹

Even more controversial is whether a lawyer is disqualified from representing a trustee or debtor-in-possession if a client in an unrelated matter does not consent but the representation of the client in the unrelated matter will not adversely impact the representation of the trustee or debtor-in-possession. This possibility is the subject of a debate among representatives of the Business Bankruptcy Ethics Committee, the National Bankruptcy Conference ("NBC"),³²² the Reporters for the *Restatement*, and Judge Carolyn D. King.³²³

The NBC submitted a memorandum to Professor Wolfram urging greater flexibility:

The Conference would urge that Chapter 8 of the *Restatement* be clarified to make clear that conflict of interest principles designed to address non-bankruptcy "civil litigation", such as those contained in Section 209, should not automatically be applied to the entirety of a bankruptcy case. While the conflict of interest principles applicable to civil litigation may properly be applied to an adversary proceeding or contested matter where the debtor, trustee or creditors' committee is asserting or defending against a claim, it should not be presumed that bankruptcy counsel is materially adverse to individual stakeholders with regard to other matters in the case. The appropriate section of the *Restatement* under which such

321. Response to Assertion That Gerald K. Smith Is Not "Disinterested" and Therefore Not Eligible to Be Examiner at 9-10, *In re Revco D.S., Inc.* (Bankr. N.D. Ohio May 22, 1990) (Nos. 588-1308 through 588-1321, 588-1305, 588-1761 through 588-1812, and 588-1820).

322. The National Bankruptcy Conference is a non-profit, voluntary association of about 65 judges, professors and practicing attorneys from all parts of the United States. Its members are selected for demonstrated professional and technical excellence in the field of bankruptcy law. The Conference was founded in the middle 1930s to promote the improvement of the bankruptcy laws and their administration. The Conference, which meets twice a year, has been consistently active in the legislative process. It assisted and advised Congress in drafting the Chandler Act of 1938 and played major roles in the enactment of the current Bankruptcy Code in 1978 and the amendment process ever since. The NBC has no staff, paid or unpaid, and operates on a budget of approximately \$40,000 per year of cash contributions from members plus various "in kind" expenditures by members for the NBC's benefit (e.g., plane fares of members, photocopies, etc.).

323. Judge King is a member of The Council of The American Law Institute and a Judge on the Fifth Circuit Court of Appeals.

other matters should be tested is Section 201, which requires a determination of the actual risk of material adversity.³²⁴

Mr. Donald S. Bernstein, a partner of Davis, Polk & Wardwell and a Conferee of the NBC, also expressed a need for greater flexibility and succinctly set forth an interesting and somewhat novel view equating pre and post bankruptcy conflict analysis.³²⁵ Mr. Bernstein's analysis, if accepted, would preclude a per se disqualification because of the representation of a party in interest in an unrelated matter.³²⁶ Disqualification would occur if there

324. Memorandum from the Committee on Professional Responsibility of the National Bankruptcy Conference to Professor Charles W. Wolfram 4 (April 18, 1996).

325. Memorandum from Donald S. Bernstein, Davis, Polk & Wardwell, to Professor Charles W. Wolfram (October 3, 1996) (on file with author).

I have given a great deal of thought to the new version of the commentary to the Restatement you have proposed regarding the treatment of bankruptcy cases under Section 209 of the Restatement. I believe the revisions are on the right track, but some of the distinctions suggested by the revisions may reflect an important gap in understanding between non-bankruptcy "litigators" and bankruptcy lawyers over the meaning of bankruptcy proceedings. I thought it might be helpful to elaborate on where I see this "gap" to be in the hope it might illuminate our further discussion of the draft commentary.

I do not see the bright line distinction between the pre and post-filing period that is suggested by the draft. In business reorganization (chapter 11) cases, most of the disputes between clients will be the same ones that existed prior to bankruptcy in the context of efforts to restructure out of court: are the claims valid, are the liens good, how should the company's debt be scaled back, how much equity should the old equity holders retain. Although after the filing the court will be involved in determining whether these disputes give rise to a conflict (because the court must approve retention of counsel by the DIP), from the lawyer's perspective, the potential disputes have not, in the main, changed.

This leads me to ask why, if the treatment of creditors is still the subject of negotiation rather than litigation, the ground rules should change by virtue of the fact that the debtor comes under court supervision by filing a petition. One might take the view, instead, that if the per se civil litigation rule did not apply to the pre-bankruptcy situation, the fact of the filing should not change this unless and until the issues between the parties degenerate into litigated disputes in the case. Prior to that time - and in the pre-filing context as well—the general rules stated in Sections 201 and 209(1) should apply. There may well be a conflict, but it is *not* generated by the pendency of the bankruptcy case. It is generated, if at all, because the parties are on opposite sides of the table trying to resolve disputes in a negotiated restructuring.

Maybe we haven't been clear on this point because it is so intuitive to those of us in bankruptcy practice: *most chapter 11 cases are in the eyes of bankruptcy practitioners a continuation of an out of court restructuring transaction.* The fact that a bankruptcy proceeding has been commenced does not mean, at least to the bankruptcy lawyer, that all aspects of the relations between the parties have become the subject of litigation.

Id. at 1-2.

326. For a similar analysis, see Letter from Geoffrey C. Hazard, Director, American Law

were a substantial risk that the representation of the client would be materially and adversely affected or when a defense or claim is asserted. On the other hand, if Judge King's position is accepted and the bankruptcy case as a whole is treated as a civil lawsuit under section 209(2), counsel for a party in interest in unrelated matters will be disqualified, absent appropriate consent, from representing a trustee or debtor-in-possession if the clients are considered to be aligned in opposition. This will be so because of state ethical rules rather than the Bankruptcy Code.

But now we are in danger of mixing apples and oranges. The Bankruptcy Code precludes counsel from holding or representing an adverse interest. That is the focus of section 201; however, section 201 is the Reporter's formulation of the state disqualifying rule and can be avoided by consent.³²⁷ But the

Institute, to Gerald K. Smith (March 15, 1996) (on file with author).

The black letter refers to conflicts arising from "representing one client in asserting or defending a claim against another client currently represented by the lawyer. . ."

Key terms are:

- "Asserting" and "defending." The fact that a client *files* a claim in bankruptcy does not mean that the claim is being "asserted" in the conflict-of-interest sense. The same point applies to a client against whom another client files a claim. At the stage of filing a claim, it is unknown whether the claim will be contested and hence whether "asserting" or (its correlative) "defending" will eventuate. Rather, as I suggested in an earlier conversation, it seems to me the key is whether a claim by or against a client is under court-supervised accounting and negotiation, i.e., bankruptcy without active litigation, or is being actually contested.

- "Representing [a] client." If the client does the filing the lawyer is not representing the client. As I understand normal practice, a client-claimant usually prepares ordinary claims and a client-debtor usually itself receives and initially processes claims made against it. If the lawyer's representation is defined in terms of a boundary at that line, then the lawyer does not represent the client until contest is in prospect.

It seems to me the foregoing analysis applies, at least in general, to Chapter 11 proceedings.

Note also the discussion in the Comment about class suits. It seems to me that much of this discussion applies as among claimants in a bankruptcy.

Id. at 1-2.

327. Section 201 precludes representation involving a conflict "[u]nless all affected clients and other necessary persons consent to the representation under the limitations and conditions provided in § 202." RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 201 (Proposed Final Draft No. 1, 1996). Section 202 of the *Restatement* provides:

(1) A lawyer may represent a client notwithstanding a conflict of interest prohibited by § 201 if each affected client or former client gives informed consent to the lawyer's representation. Informed consent requires that the client or former client have reasonably adequate information about the material risks of such representation to that client or former client.

(2) Notwithstanding the informed consent of each affected client or former client, a lawyer may not represent a client if:

(a) the representation is prohibited by law;

disqualification under the Bankruptcy Code is not cured by consent.

Even if the case as a whole is not considered civil litigation under section 209(2), the lawyer will be disqualified under section 201 in those instances where the relationship or connection to the other client is significant. The *In re Amdura*³²⁸ case is a good illustration of this. In *Amdura* there was such a significant client relationship between the Winston & Strawn law firm and Continental Bank that Winston & Strawn was unwilling to be adverse to Continental Bank. It was, therefore, not only a disqualifying relationship under the Bankruptcy Code but also section 201.

The state rules of disqualification, at least from the perspective of bankruptcy practice, have been progressively stiffened over the last quarter century. The Canons were not clear even as to civil litigation. The *Rottnier* case could have gone either way under the old Canons. Canon 6 stated that it was "unprofessional to represent conflicting interests, except by express consent of all concerned."³²⁹ A lawyer represented conflicting interests under Canon 6 "when, in behalf of one client, it is his duty to contend for that which duty to another requires him to oppose."³³⁰ This definition did not clearly cover the client in the unrelated matter. The Model Code precludes the representation of differing interests, and this seems to cover the client in an unrelated matter.

In contrast, the Model Rule is clear on this issue. It precludes representation "if the representation . . . will be directly adverse to another client."³³¹ The only possible question in the bankruptcy context is whether the general representation, for example, of a debtor-in-possession or trustee is directly adverse to another client in an unrelated matter who is a party in interest. This is similar to the issue under section 209(2) of the *Restatement*. It is only phrased differently, i.e., is the representation directly adverse to a client in an unrelated matter rather than is a claim or defense asserted against the client in the unrelated matter.

Judge Alan Shiff, in *In re Peck*,³³² refused to disqualify counsel for the debtor-in-possession where such counsel formerly represented a creditor in documenting a loan to the debtor. Judge Shiff looked at the facts, rather than applying a per se rule as did the Arizona Supreme Court in *In re Breen*. He found no basis for disqualification where the integrity and validity of the

(b) one client will assert a claim against the other in the same litigation; or

(c) in the circumstances, it is not reasonably likely that the lawyer will be able to provide adequate representation to one or more of the clients.

Id. § 202.

328. 121 B.R. 862 (Bankr. D. Colo. 1990).

329. CANONS OF PROFESSIONAL ETHICS Canon 6 (1908).

330. *Id.*

331. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.7(a) (1995).

332. 112 B.R. 485 (Bankr. D. Conn. 1990).

documentation could not be challenged although the possibility of a suit to recover a preference because of improvements to the collateral existed.³³³

On the other hand, in determining whether a lawyer has a conflict under the adverse interest standard, the lawyer must consider whether it is likely that a client in an unrelated matter will initiate a motion to lift stay, a motion to convert, a motion to dismiss, or a motion to compel the assumption of a contract. If so, the lawyer for the trustee or debtor-in-possession would be disqualified from handling the matter since, under section 209(2) of the *Restatement*, one client would be represented in asserting or defending a claim against another client currently represented by the lawyer in an unrelated matter. This would limit the lawyer's role and, as in *Amdura*, likely result in disqualification under the Bankruptcy Code.

E. Representing Multiple Parties-In-Interest in a Chapter 11 Case.

Multiple representation raises significant conflict issues. By way of example, can you represent secured and unsecured creditors in a reorganization case? The rights of secured creditors in a reorganization case are adverse to the rights of unsecured creditors. It is true that secured and unsecured creditors may be aligned for purposes of reorganization. However, in reaching this goal many disputes among parties in interest must be negotiated or litigated. For example, the holder of a secured claim may have received a transfer which is voidable and the same is often true of unsecured creditors. Some unsecured creditors may have reclamation rights or the ability to perfect liens postpetition; to that extent, their rights conflict with the rights of other creditors. Parties having prepetition contractual relationships with the debtor may not only hold unsecured claims (and potential offset rights), but may wish to terminate the contractual relationships. Holders of unsecured, subordinated claims are often represented by a committee. Positions taken by the committee or individual holders of subordinated claims will often be directly adverse to the interests of other unsecured creditors. Even general, unsecured creditors interests differ since the total of the unsecured claims may affect the amount of the distribution to unsecured claimants.

Section 209(1) of the *Restatement* precludes multiple representation in civil litigation "if there is a substantial risk that the lawyer's representation of one of the clients would be materially and adversely affected by the lawyer's duties to another client in the matter."³³⁴ Comment d to section 209(1) makes it clear that the rule applies to bankruptcy cases.³³⁵

333. *Id.* at 488 n.4.

334. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 209(1) (Proposed Final Draft No. 1, 1996).

335. It is assumed that the draftsman of the Commentary to § 209(1) did not use "bankruptcy proceeding" in a technical sense. If it was used in a technical way, it does not refer to multiple

Multiple representation is precluded when the clients, although nominally on the same side of a lawsuit, in fact have such different interests that representation of one will have a material and adverse effect on the lawyer's representation of the other. Such conflicts can occur whether the clients are aligned as co-plaintiffs or co-defendants, as well as in complex and multi-party litigation.³³⁶

Not all possibly differing interests of co-clients in complex and multi-party litigation involve material interests creating conflict. Determination whether a conflict of material interests exists requires careful attention to the context and other circumstances of the representation *For example, a lawyer might represent several unsecured creditors in a bankruptcy proceeding.* In addition to general conflict of interest rules that may apply, a lawyer representing such multiple clients must also comply with statutory regulations if more stringent.³³⁷

The *Restatement* terminology is difficult to apply; it requires that one focus on the adequacy of the representation of one of the clients where the duties to another client nominally aligned may materially and adversely affect the representation's quality or extent.

Section 211 of the *Restatement* covers multiple representation other than in litigation. It provides that, absent appropriate consent:

[A] lawyer may not represent two or more clients in a matter not involving litigation if there is a substantial risk that the lawyer's representation of one or more of the clients would be materially and adversely affected by the lawyer's duties to one or more of the other clients.³³⁸

As made clear in comment a, this section concerns the propriety of the representation of "co-clients."³³⁹ The comments to section 209 mention what may be the most common instance of multiple representation in bankruptcy cases, the representation of two or more creditors.³⁴⁰ But there is no mention of the important issues of joint administration by one trustee,³⁴¹ presentation

representation in the case, but rather in a contested proceeding. NORTON BANKRUPTCY RULES PAMPHLET, pp. iii-iv (1996-97).

336. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 209 cmt. d (Proposed Final Draft No. 1, 1996).

337. *Id.* § 209 cmt. d (iii) (emphasis added).

338. *Id.* § 211.

339. *Id.* § 211 cmt. a.

340. *Id.* § 209 cmt. d(iii).

341. BANKR. R. 2009(a), (c), (d). Rule 2009(d) is labelled "potential conflicts" and requires a showing of prejudice as a result of conflicts before separate trustees will be ordered.

of creditors' committees,³⁴² or representation of debtors-in-possession in related cases.

The approach of sections 209(1) and 211 is a circumstances approach, in contrast to the per se disqualification of the Model Code. The relevant Ethical Consideration of the Model Code is as follows:

A lawyer should never represent in litigation multiple clients with differing interests; and there are few situations in which he would be justified in representing in litigation multiple clients with potentially differing interests. If a lawyer accepted such employment and the interests did become actually differing, he would have to withdraw from employment with likelihood of resulting hardship on the clients; and for this reason it is preferable that he refuse the employment initially.³⁴³

The Model Rule Commentary suggests an approach similar to that of the *Restatement*.

Simultaneous representation of parties whose interests in litigation may conflict, such as co-plaintiffs or co-defendants, is governed by paragraph (b) [conflicts caused by material limitations on lawyer's ability to represent]. An impermissible conflict may exist by reason of substantial discrepancy in the parties' testimony, incompatibility in positions in relation to an opposing party or the fact that there are substantially different possibilities of settlement of the claims or liabilities in question. . . . [C]ommon representation of persons having similar interests is proper if the risk of adverse effect is minimal and [the clients consent].³⁴⁴

The Canons also seem to contain a per se rule precluding multiple representation, absent appropriate consent.

It is unprofessional to represent conflicting interests, except by express consent of all concerned given after a full disclosure of the facts. Within the meaning of this canon, a lawyer represents conflicting interests when, in behalf of one client, it is his duty to contend for that which duty to another client requires him to oppose.³⁴⁵

342. See *In re Caldor*—NY, 193 B.R. 165 (Bankr. S.D.N.Y. 1996).

343. ANNOTATED CODE OF PROFESSIONAL RESPONSIBILITY EC 5-15 (1979).

344. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.7 cmt. 7 (1995).

345. CANONS OF PROFESSIONAL ETHICS Canon 6 (1908).

Representation of several creditors in bankruptcy cases was discussed in an article by Kent Meyers shortly before the enactment of the present Code.³⁴⁶

In many instances, the firm will be representing more than one old, established client. Perhaps, the firm will have accepted representation of a new client before being aware of a claim by a long-time client. These circumstances make withdrawal from or refusal of representation difficult at best.

If a question of the priority of a secured claim or validity of any type of claim is or could be raised, the differing or conflicting interests become evident and are the very type of conflicting interests that are anathema to lawyers and clients alike.

In bankruptcy, it appears to be a rather common practice for a law firm to represent numerous unsecured creditors. In a "no asset" liquidation or straight bankruptcy proceeding seemingly, there would be no conflict. However, where there will be assets to allow the payment of a dividend, the possibility of conflicting or competing claims arises and hence, the ethical difficulties. In the representation of secured and unsecured creditors in straight bankruptcy the conflicts arise because of the possibility of conflicting claims, preferential transfers or fraudulent conveyances.

In rehabilitation proceedings (Chapters X, XI, XII and XIII), all of the conflict problems that exist in the straight bankruptcy setting are again present, with the additional problems raised by the requirement for the selection of trustees, management of assets and approval of arrangement or reorganization plans.³⁴⁷

Mr. Meyers, like the Reporters for the *Restatement*, considered a bankruptcy case to be litigation.

Canon 5 deals with the problem of conflicting or differing interests. In the exercise of independent professional judgment on behalf of a client, it is stated that "a lawyer should *never* represent *in litigation* multiple clients with differing interests." (Emphasis supplied.) The Ethical Considerations, some text writers and courts state an *absolute prohibition* against representing differing interest in litigation. By definition, differing interests include ". . . every interest that will adversely affect either the judgment or the loyalty of a lawyer to a client, whether it be a conflicting, inconsistent, diverse, or other interest." Apparently, the latitude gained by full disclosure and client consent is available only in non-litigation circumstances. If that is so, the prohibition against multiple creditor representation in litigation

346. Kent Meyers, *Ethical Considerations in the Representation of Multiple Creditors Against a Single Debtor*, 51 AM. BANKR. L.J. 19 (1977).

347. *Id.* at 19-20 (footnotes omitted).

may be being honored more in its breach than in its observance, at least in bankruptcy.³⁴⁸

Mr. Meyers discusses applicable sections of the *Restatement of Agency* and a formal opinion of the American Bar Association, which he believes is in conflict with Ethical Consideration 5-15 which states that “[a] lawyer should never represent in litigation multiple clients with differing interests.”³⁴⁹ Mr. Meyers cautions that the formal opinion and the *Restatement* provisions were written well in advance of the contrary provision of the Model Code.

The authorities are not in harmony concerning what is a conflict, the effect of it arising in litigation, the efficacy of consent or withdrawal and the presumptive balance to be struck between the various competing interests. The effects of an attorney making a wrong decision are becoming more serious and drawing more attention. In the case of an erroneous decision by the attorney, there is a discernible trend toward possible disciplinary action by the applicable Bar Association and, moreover, financial responsibility to the client for malpractice.³⁵⁰

Because of the resulting uncertainty, Mr. Meyers recommended additional guidance in the form of a bankruptcy rule. However, he was skeptical that a national rule could be achieved and therefore recommended a model local bankruptcy rule.

In addition to any requirements of other applicable statutes or rules, any person representing more than one creditor shall file a signed statement with the court setting forth that:

- (1) The multiple representation has been disclosed to each such creditor;
- (2) The actual or potential conflict of interest has been discussed with each such creditor;
- (3) Each such creditor has agreed to the multiple representation;
- (4) The signor shall advise all such creditors and the court should any material change take place that disqualifies the signor from continuing the multiple representation.³⁵¹

The dispute among the representatives of the NBC, Business Bankruptcy Ethics Committee and Judge King is irrelevant to the type of conflict addressed

348. *Id.* at 21 (footnotes omitted).

349. ANNOTATED CODE OF PROFESSIONAL RESPONSIBILITY EC 5-15 (1979).

350. Meyers, *supra* note 346, at 25.

351. *Id.* at 29.

by Meyers. Multiple representation of this type would be treated the same by the *Restatement* whether section 201 or section 209(1) applies.

In a discussion of representation of multiple clients in the same matter, Professor Nancy J. Moore³⁵² compared the then proposed Model Rules with the Model Code. Professor Moore found both the Model Code and the Model Rules inadequate. "The current ABA Code states that such multiple representation can be proper if informed consent is obtained, but only if it is 'obvious' that the representation will be 'adequate.' Unfortunately, no disciplinary rule defines 'adequate' and the little guidance provided in the Code's ethical considerations is, at best, ambiguous."³⁵³

As for the Model Rules, Professor Moore found that the "attempt to clarify the meaning of 'adequacy' by substituting a rule which asks whether the 'lawyer reasonably believes that the representation will not be adversely affected'"³⁵⁴ only perpetuated the confusion. "Although the exclusive focus on client interests eliminates any need to consider the potential for apparent improprieties, the new rule provides no guidance on how to determine the 'adverse' effect of the conflict on the representation."³⁵⁵ The Association of Trial Lawyers of America had proposed an alternative which would have solved the problem, but it abandoned any protection of clients against potentially unwise decisions. The proposal was that "a client can waive any conflict of interest after . . . full disclosure."³⁵⁶ After discussing the inadequacies of the ABA Code, the proposed Model Rules and a proposal of the American Trial Lawyers Association, Professor Moore recommended "a new general standard based upon client capacity for informed and voluntary consent."³⁵⁷

(A) A conflict of interest exists whenever a lawyer's ability to consider, recommend, or carry out a course of action on behalf of a client is or may be adversely affected by the lawyer's responsibilities to another client.

(B) The representation of conflicting interests is impermissible unless:

(1) the lawyer fully explains to each client the implications of the conflict of interests, including the advantages and risks involved, and obtains each client's consent in writing; and

352. Nancy J. Moore, *Conflicts of Interest in the Simultaneous Representation of Multiple Clients: A Proposed Solution to the Current Confusion and Controversy*, 61 TEX. L. REV. 211 (1982).

353. *Id.* at 212-13 (footnotes omitted).

354. *Id.* at 214 (footnotes omitted).

355. *Id.*

356. *Id.* at 215.

357. *Id.* at 216.

(2) the lawyer reasonably believes that each client is capable of giving informed and voluntary consent, taking into account both the subject matter and the individuals involved.³⁵⁸

Section 202 of the *Restatement* sets forth the rule on client consent to conflicts of interest. Regardless of consent, an attorney may not represent opposing parties in the same litigation. Thus, if a bankruptcy case is litigation, as that term is used in the *Restatement*, even consent will not allow a lawyer to represent adversaries aligned in opposition. Comment g(iii) to section 202 discusses the situation of when clients are aligned directly against each other.

In multi-party litigation, a single lawyer might, for example, represent members of a class in a class action, multiple creditors or debtors in a bankruptcy proceeding, or multiple interested parties in environmental clean-up litigation. Joint representation is appropriate following effective client consent, together with compliance with applicable statutory or rule requirements, which may require court approval of the representation after a disclosure of the conflict.³⁵⁹

F. *Representing Affiliates in a Chapter 11 Case.*

An organization with more than a single owner-employee is an aggregation of multiple interests, if only because it is made up of multiple persons or entities. Persons initially forming an organization are linked by a common interest that partly transcends their individual interests. The individuals might have separate lawyers for their other activities and for negotiating the question of their shares or other forms of control in the organization. However, a lawyer might be retained for representation relating to the organization separate from that of any individual associated with the enterprise. An organization's lawyer thus is said to represent the entity and not the elements that make it up. A lawyer for an organization serves whatever lawful interest the organization defines as its interest, acting through its responsible agents and in accordance with its decision-making procedures.³⁶⁰

The foregoing description from the comments to *Restatement* section 212 succinctly describes entity representation. The question remains, however, whether the lawyer representing the entity can also represent owners, management or related entities. Simultaneous representation in the same matter is dealt with by section 212(2) which adopts the basic conflict rule and

358. *Id.* at 287.

359. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 202 (Proposed Final Draft No. 1, 1996).

360. *Id.* § 212 cmt. b.

precludes the lawyer for the entity from representing "a director, officer, employee, shareholder, owner, partner, member, or other individual or organization associated with the organization if there is a substantial risk that the lawyer's representation either would be materially and adversely affected by the lawyer's duties to the other without appropriate consent."³⁶¹

The Model Code would seem to preclude such simultaneous representation as adverse. Disciplinary Rule 5-105(A) requires a lawyer to decline employment "if the exercise of his independent professional judgment in behalf of a client will be or is likely to be adversely affected by the acceptance of the proffered employment, or if it would be likely to involve him in representing differing interests."³⁶² Under Disciplinary Rule 5-105(B) the lawyer must discontinue multiple employment "if the exercise of his independent professional judgment in behalf of a client will be or is likely to be adversely affected by his representation of another client, or if it would be likely to involve him in representing differing interests."³⁶³ In both instances, Disciplinary Rule 5-105(C) allows the representation if there is informed consent and "it is obvious that he can adequately represent the interests of . . . [all of the clients]."³⁶⁴ The Model Rules are similar; however, Model Rule 1.7(b)(2) adds that "[w]hen representation of multiple clients in a single matter is undertaken,"³⁶⁵ the consultation which precedes consent must include "explanation of the implications of the common representation and the advantages and risks involved."³⁶⁶

When confronted with a multiple representation situation, bankruptcy counsel should fully comply with the requirements of the applicable state ethical rules. The spelling out of the consultation in the required disclosure under Bankruptcy Rule 2104 will be of assistance to the bankruptcy judge in determining whether to allow the multiple representation.

Many bankruptcy judges preclude simultaneous representation of the debtor and an owner, partner, member, director, officer, employee or shareholder but allow representation of affiliated entities because of the expense and impracticality of multiple representation. The issue under the adverse interest standard is straight forward: Will the representation of each client be materially and adversely affected by the representation of the other? However, under the disinterested standard there may be a per se disqualification if there is a claim by or against the affiliate. This arguably makes the trustee a creditor of the affiliate since the trustee has a duty to assert the claim against the affiliate. However, the entity still exists, although its assets comprise an estate.

361. *Id.* § 212.

362. ANNOTATED CODE OF PROFESSIONAL RESPONSIBILITY DR 5-105(A) (1979).

363. *Id.* at DR 5-105(B).

364. *Id.* at DR 5-105(C).

365. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.7(b)(2) (1995).

366. *Id.*

Even if there is a new entity—the estate—the trustee represents it, however, the trustee does not become a creditor of the affiliate. Thus, there should be no per se disqualification.

The same analysis should apply whether the potentially disqualifying basis is a creditor claim or ownership interest.

An attorney should not seek approval to represent affiliated debtors or a debtor and its insider unless the attorney has: (1) evaluated the affiliate's or insider's relationship with the debtor, e.g. intercompany claims, asset transfers, overlapping creditors, creditor guaranties and subordination agreements, jointly-owned assets, shared officers, directors and owners; (2) determined that the interests of both prospective clients are substantially aligned with respect to the proposed representation, and that there is no substantial risk that the attorney's representation of each client would be materially and adversely affected by the attorney's duties to the other; and (3) obtained the consent of each prospective client to representation by separate counsel if and when appropriate to handle disputes between them.

Because affiliates and insiders are interested parties with respect to the decision on consenting to joint representation, and because of the Bankruptcy Code's disinterestedness requirements and the fiduciary duties of debtors in possession to creditors and equity security holders, the bankruptcy court should be informed of all relevant facts, and determine whether joint representation and consent to joint representation is appropriate, upon appropriate notice to creditors and parties in interest. See § 202g(ii).³⁶⁷

G. Representing Parties in Interest with Inconsistent Positions: Positional Conflict.

If there is one thing certain as far as bankruptcy practice it is that counsel will assert inconsistent positions on legal issues. For example, since the Bankruptcy Code does not specify the date of valuation of collateral, counsel will argue the most beneficial date. Inconsistent positions will be asserted even if one limits one's practice to representation of secured creditors. The problem is magnified many fold where one represents creditors—both secured and unsecured including claims traders—debtors, trustees and committees. In a large firm, lawyers will undoubtedly be taking contrary legal positions before the same bankruptcy judge on a number of issues. Is this disqualifying?

Model Rule 1.7 addresses the issue head on:

367. ABA Business Bankruptcy Law Committee, Bankruptcy Ethics Subcommittee, *Restatement of the Law, The Law Governing Lawyers, Bankruptcy Issues*, Panel Paper Presented at the American Law Institute Conference in Orlando, Florida 4-5 (1993).

A lawyer may represent parties having antagonistic positions on a legal question that has arisen in different cases, unless representation of either client would be adversely affected. Thus, it is ordinarily not improper to assert such positions in cases pending in different trial courts, but it may be improper to do so in cases pending at the same time in an appellate court.³⁶⁸

A recent formal opinion of the ABA Standing Committee on Ethics and Professional Responsibility made it clear that, absent appropriate consent, if two matters are being litigated in the same jurisdiction the lawyer must avoid taking inconsistent positions if there "is a substantial risk that the law firm's representation of one client will create a legal precedent, even if not binding, which is likely materially to undercut the legal position being urged on behalf of the other client."³⁶⁹

The *Restatement* devotes two paragraphs in a comment to section 209 to the problem. The issue is dealt with like other conflicts of interest under section 201.

A lawyer ordinarily may take inconsistent legal positions in different courts at different times. While each client is entitled to the lawyer's effective advocacy of that client's position, if the rule were otherwise law firms would have to specialize in a single side of legal issues.

However, a conflict is presented when there is a substantial risk that a lawyer's action in Case A will materially and adversely affect another of the lawyer's clients in Case B. Factors relevant in determining the risk of such an effect include whether the issue is before a trial court or an appellate court; whether the issue is substantive or procedural; the temporal relationship between the matters; the practical significance of the issue to the immediate and long-run interests of the clients involved; and the clients' reasonable expectations in retaining the lawyer. If a conflict of interest exists, absent informed consent of the affected clients under § 202, the lawyer must withdraw from one or both of the matters. Informed client consent is provided for in § 202. On circumstances in which informed client consent would not allow the lawyer to proceed with representation of both clients, see § 202(2)(c) and Comment *g(iv)* thereto.³⁷⁰

In the *Revco* cases, Weil, Gotshal & Manges, on behalf of D.S. Partners, objected to the appointment of the author as examiner on the basis of a conflict

368. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.7 cmt. 9 (1995).

369. ABA Comm. on Ethics and Professional Responsibility, Formal Op. 377 (1993) (discussing positional conflicts).

370. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 209 cmt. f (Proposed Final Draft No. 1, 1996).

arising from Lewis & Roca having taken certain positions in the *Kaiser Steel* leveraged buyout litigation.

6. On behalf of Kaiser Steel Resources, Inc., . . . Lewis & Roca, Smith's law firm, has filed three complaints stating numerous causes of action relating to the 1984 leveraged buyout of Kaiser Steel Corporation. These complaints seek recovery from, among others, the selling stockholders of Kaiser Steel, the banks who financed the leveraged buyout and the board of directors that authorized the transactions. . . . The Kaiser Steel complaints and the quoted allegations contain implicit assumptions of law applicable to fraudulent transfer claims in general. In view of the fact that Smith and Lewis & Roca are currently and actively prosecuting the Kaiser Steel litigation, D.S. Partners submits that Smith and Lewis & Roca will be unable in an objective fashion to investigate and report on the Revco leveraged buyout and any claims or causes of action related thereto.

7. Necessarily, the examiner's investigation, report and recommendations will involve the consideration of numerous complex and controversial issues and will propose actions to be undertaken in connection therewith. For example, if all creditors in existence on the date of the leveraged buyout have been paid in full before Revco's financial difficulties arose, should the selling stockholders or the entities that lent money to Revco be liable to creditors who, in effect, assumed the risk associated with Revco's leveraged buyout? Even the applicability of the fraudulent transfer provisions of the Bankruptcy Code and analogous state law statutes is subject to considerable doubt. . . . In light of the positions taken by Lewis & Roca in the Kaiser Steel litigation and the potential prejudice to such litigation if Smith publicly recommended against litigating claims arising out of Revco's leveraged buyout, Smith's ability to objectively evaluate issues relating to the Revco LBO must be questioned.³⁷¹

371. Objection of D.S. Partners, L.P. to Appointment of Examiner and Recommendation Regarding Scope of Examiner's Duties at 5-7, *In re Revco D.S., Inc.* (Bankr. N.D. Ohio May 17, 1990) (Nos. 588-1308 through 588-1321, 588-1305, 588-1761 through 588-1812, and 588-1820). Fried, Frank, Harris, Shriver & Jacobson, on behalf of the Noteholders Committee, objected on the same basis.

Mr. Smith has been, to our understanding, the lead prosecutor in the Kaiser Steel Fraudulent Conveyance Litigation for almost three years. If he is the lawyer we think him to be, he has devoted a good portion of those last three years to thinking about new fraudulent conveyance theories to prosecute, and being a zealous advocate for them.

His duty to his client—in the Kaiser Steel Fraudulent Conveyance Litigation—demands no less. But attitudes developed after years of advocacy on behalf of LBO-related fraudulent conveyance claims cannot easily be pushed to the side. Nor can any person push to the side the possibility that decisions as to the merits of fraudulent conveyance claims in this case may ultimately have precedential value in the case being litigated elsewhere. While we have no doubt that a person of integrity would try to push aside such concerns, it is improbable that anyone so trying could really be

The response argued that the examiner should not be disqualified under general principles of disqualification law and under the disinterested standard.

This matter can be approached in terms of the Bankruptcy Code or in terms of general principles of disqualification law. The examiner will be regarded as a quasi-judicial officer of the court; the citations to various cases for that proposition in the papers already filed are valid. . . .

It is generally accepted that a judge who has been counsel to a party is disqualified but only as to those matters where there has been an attorney-client relationship as to the particular cases which come before him as a judge; "a judge is not disqualified from hearing a case merely because it has grown out of a previous case in which he has acted as counsel. . . or where the first case involved some of the issues raised in the second. . . ," 44A C.J.S. Judges, § 114(b), p. 761.

. . . .

The federal statute (and in this respect the ABA canons of judicial ethics are the same) carefully disqualify the judge for previous association only where he had, as a lawyer, "served as a lawyer in the matter in controversy," 28 U.S.C. § 455(b) and the ethics opinions as to a lawyer who has left the bench are similarly confined; see Op. 59, ABA Committee on Professional Ethics (1931), where a lawyer as special master decided an oil rights case in a particular fashion; his firm cannot thereafter seek to enforce the judgment.

. . . .

We have endeavored to research the scope of the "disinterestedness" definition of the Bankruptcy Code, 11 U.S.C. § 101(13). Every single case we have found in which a person is held "interested" rather than "disinterested" involves the person's connection to the bankruptcy estate before the court. There is no recorded instance in which anyone has been found "interested" because of involvement in some other case representing other parties who have no connection with the bankruptcy case before the court.³⁷²

successful. And, even if successful, the appearance of bias could not be overcome. Response of Official Committee of Unsecured Noteholders in Opposition to Application of United States Trustee for Order Appointing Gerald K. Smith, Esq. as Examiner at 6, *In re Revco D.S., Inc.* (Bankr. N.D. Ohio May 17, 1990) (Nos. 588-1308 through 588-1321, 588-1305, 588-1761 through 588-1812, and 588-1820).

372. Response to Assertion That Gerald K. Smith Is Not "Disinterested" and Therefore Not Eligible to Be Examiner at 2-6, *In re Revco D.S., Inc.* (Bankr. N.D. Ohio May 22, 1990) (Nos. 588-1308 through 588-1321, 588-1305, 588-1761 through 588-1812, and 588-1820).

IV. CONFLICT RULES FOR THE TWENTY-FIRST CENTURY

The Business Bankruptcy Ethics Committee has been reviewing and commenting on proposed drafts of the evolving *Restatement* for some time. Professor Tom Morgan, the Reporter for the Conflicts Chapter of the *Restatement*, was first alerted to the interest of the Business Bankruptcy Ethics Committee in 1991. Another Subcommittee of the Business Bankruptcy Committee,³⁷³ under the leadership of its chair, David A. Murdoch, joined the effort in 1993. The Committees held joint panel discussions in Orlando in October of 1993 and Washington, D.C. in April of 1994 to review portions of the *Restatement* of particular interest to the Subcommittees. Professor Morgan was informed of the concerns of the Subcommittees through papers prepared for the Orlando and Washington, D.C. panels on which Professor Morgan participated.

The Orlando paper set forth specific issues.

The Ethics Subcommittee of the Business Bankruptcy Committee of the American Bar Association urges that specific reference be made in the *Restatement* to (1) the ability of an attorney to file a bankruptcy petition when the attorney's law firm presently represents one or more creditors or equity security holders on unrelated matters; (2) the ability of an attorney to represent a debtor-in-possession in a bankruptcy reorganization case and also represent persons and entities affiliated with that debtor; (3) the circumstances in which an attorney's connections with the debtor result in material adversity, apart from the disinterestedness rule; (4) the impact of the fact that a debtor-in-possession is a fiduciary on the fiduciary duties of counsel for the debtor-in-possession and liability to non-clients; (5) the impact of the appointment of a trustee on the "control" of the attorney-client privilege; and (6) whistle blowing in bankruptcy cases. The timing of seeking any waivers from other clients on the first issue and the ability of the affiliates to provide waivers on the second issue should also be addressed.³⁷⁴

373. The Subcommittee on Committees, Trust Indentures and Claims Trading of the Business Bankruptcy Committee.

374. ABA Business Bankruptcy Law Committee, Bankruptcy Ethics Subcommittee, *Restatement of the Law, The Law Governing Lawyers, Bankruptcy Issues*, Panel Paper Presented at the American Law Institute Conference in Orlando, Florida 2 (1993) (on file with author).

In a bankruptcy context, a distinction should be recognized between (1) objecting to a creditor's claim or pursuing an adversary proceeding or otherwise taking a position directly adverse to the unique interest of a creditor client, e.g. with respect to use of the security for its claim or its contract rights, and (2) taking positions on matters generally affecting all creditors and parties in interest in a bankruptcy case adverse to the position a creditor client might take, e.g. with respect to a sale of estate assets.

Further, guidance should be offered as to when the mere filing of a bankruptcy petition may materially and adversely affect existing clients of the attorney's law firm.

The Washington paper set forth the joint opposition of the Committees to section 73 of the *Restatement* to the American Law Institute at its annual meeting in 1994.

We would like to bring to the attention of the members of the American Law Institute an additional concern. Section 73 attempts to restate the law of duties to non-clients. Paragraph (3) thereof provides that a lawyer owes the duty to use care to someone other than a client "when and to the extent that the lawyer knows that a client intends the lawyer's services to benefit the non-client, and such a duty substantially promotes enforcement of the lawyer's obligations to the client and would not create inconsistent duties significantly impairing the lawyer's performance of those obligations."

We are concerned because of the uncertain nature of the potential liability of lawyers representing those acting in a fiduciary capacity under the insolvency and bankruptcy laws as well as those representing financially distressed entities. We are also troubled by the potentially large number of claimants. Section 73 contains no discussion of the duty, if any, of a lawyer representing such fiduciaries or those in control of a financially distressed entity not involved in a case under the Bankruptcy Code or an insolvency proceeding. A duty to a non-client may be appropriate if the fiduciary is a trustee of a common law trust, where the rules are relatively straight forward and well established. But it is much less certain that there should be a duty to a non-client on the part of a lawyer representing a bankruptcy trustee, examiner, creditors committee, or those in control of a debtor-in-possession. This is compounded by the uncertainty of the fiduciary duties of those represented.³⁷⁵

The subcommittee proposes that such a determination will turn on the size of the claim or stake in the bankruptcy case, measured from the perspective of both the debtor and the creditor, and the intended treatment of the claim or equity stake, if known. Thus, the firm's representation of a creditor on an unrelated matter, where the creditor holds a claim that is relatively small, or representation on an unrelated matter of the holder of a small percent of the equity interests in a publicly traded debtor company, or representation on an unrelated matter of a creditor whose rights the debtor does not intend to impair (e.g. through prompt assumption and continued performance of the parties' contract) would not preclude representation of the bankruptcy debtor without obtaining the creditor client's consent.

The attorney undertaking such debtor representation should plan on and seek court approval for separate counsel to handle litigation of objections to a creditor client's claim, pursuit of any adversary proceeding, or otherwise seeking to determine any position directly adverse to the unique interest of a creditor client, should any such matters arise during the case.

Id. at 3-4.

375. Memorandum from Gerald K. Smith and David A. Murdoch, Chairs of the Ethics Subcommittee and Subcommittee on Committees, Trust Indentures and Claims Trading of the

Others found section 73 troublesome as well, including ALAS. The section was recommitted to the Reporters and eventually resubmitted to the Council and approved in a less troublesome form.³⁷⁶

Although the joint opposition primarily concerned section 73, general concerns about the treatment of a bankruptcy case were also expressed.

Business Bankruptcy Committee of the Business Section of the American Bar Association, to Professor Charles W. Wolfram, Reporter for *Restatement (Third) of the Law Governing Lawyers* 2-3 (May 11, 1994) (on file with author).

376. For the purposes of liability under § 71, a lawyer owes a duty to use care within the meaning of § 74:

(1) to a prospective client, as stated in § 27;

(2) to a non-client when and to the extent that:

(a) the lawyer or (with the lawyer's acquiescence) the lawyer's client invites the non-client to rely on the lawyer's opinion or provision of other legal services, and the non-client so relies, and

(b) the non-client is not, under applicable tort law, too remote from the lawyer to be entitled to protection;

(3) to a non-client when and to the extent that:

(a) the lawyer knows that a client intends as one of the primary objectives of the representation that the lawyer's services benefit the non-client; and

(b) such a duty would not significantly impair the lawyer's performance of obligations to the client, and the absence of such a duty would make enforcement of those obligations unlikely;

(4) to a non-client when and to the extent that:

(a) the lawyer's client is a trustee, guardian, executor, or fiduciary acting primarily to perform similar functions for the non-client;

(b) circumstances known to the lawyer make it clear that appropriate action by the lawyer is necessary with respect to a matter within the scope of the representation to prevent or rectify the breach of a fiduciary duty owed by the client to the non-client, where (i) the breach is a crime or fraud or (ii) the lawyer has assisted or is assisting the breach;

(c) the non-client is not reasonably able to protect its rights; and

(d) such a duty would not significantly impair the performance of the lawyer's obligations to the client; and

[(5) to a non-client when and to the extent that circumstances know to the lawyer make it clear that appropriate action by the lawyer is necessary with respect to a matter within the scope of the representation to prevent the client from committing a crime imminently threatening to cause death or serious bodily injury to an identifiable person who is unaware of the risk and the lawyer's act has facilitated the crime].

RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 73 (Tentative Draft No. 8, 1997).

[O]ne fails to find any reference to or analysis of the rules in the context of an insolvency or bankruptcy case. There is a substantial and rapidly developing body of law concerning not only trustees, examiners, debtors-in-possession and members of creditors committees, but also counsel for such persons. This body of law has not been referred to and presumably has not been considered in the formulation of the rules, comments and illustrations. Simply by way of example, Section 209 of Tentative Draft No. 3, absent consent, precludes a lawyer in civil litigation from representing one client against another client currently represented by the lawyer, whether or not the matters are related. If the initiation of a bankruptcy case is the initiation of civil litigation, this rule would preclude a lawyer from filing the bankruptcy case for a person any one of whose creditors or equity owners are existing clients of the lawyer. That may very well be the rule, but there is nothing in the Restatement that suggests that this very significant issue to those involved in insolvency and bankruptcy practice has been considered.

For several years the Ethics Subcommittee of the Business Bankruptcy Committee studied the Bankruptcy Code requirement that counsel for a debtor-in-possession be disinterested. Disinterestedness is a defined term under the Bankruptcy Code which came into the bankruptcy law with the enactment of Chapter X. However, that requirement was not imposed on counsel for a debtor-in-possession in a Chapter X case. It was the Subcommittee's conclusion that the Bankruptcy Reform Act of 1978 mistakenly imposed such a requirement on counsel for the debtor-in-possession in a Chapter 11 case. As a result of this study and the recommendation of the Ethics Subcommittee, the American Bar Association House of Delegates in 1991 recommended that Congress remove this requirement from the Bankruptcy Code. Legislation to that effect has not been introduced and it is doubtful that it will be. Nonetheless, the disinterestedness requirement raises a variety of concerns, some of which could be addressed in the commentary and illustrations of the Restatement. For example, it would be of great help if the reporters could furnish commentary and illustrations as to the meaning of one of the elements of disinterestedness, that is, that the lawyer not have or represent a "materially adverse interest." It would also be helpful if there could be an analysis and discussion of the similar requirement of 11 U.S.C. § 327(a), that those employed "not hold or represent an interest adverse to the estate." That was a requirement under the Bankruptcy Act which was superseded as to Chapter X reorganization cases after the effective date of the Chandler Act Amendments. By way of example, it would be very helpful if the reporters would study, analyze and comment on permissible and impermissible representation of affiliated entities in multiple bankruptcy cases. Similarly, the helpful explanation of what is a conflict in Section 201 could be of considerable assistance to insolvency and bankruptcy lawyers if comments and illustrations considered the rules in the context of insolvencies and bankruptcies.

It once was true that insolvency and bankruptcy were arcane matters that could be ignored. But that is no longer so. As early as 1973, the considerable expansion of these matters was recognized in the dissent of Justice Douglas from the order of the Supreme Court of the United States promulgating the rules and official bankruptcy forms. "I once knew most of the referees in the Nation and worked with them on various projects. But they too flourish under Parkinson's Law; and their power grows like that of a prince in a medieval kingdom." In this day of reorganizations of large, publicly held companies like Texaco, Johns-Manville and Continental Airlines, as well as cross-border insolvencies involving large multinational companies, it is submitted that insolvency and bankruptcy matters are sufficiently important and affect and touch a sufficient number of lawyers to warrant some attention. It is therefore recommended that a group of lawyers skilled in insolvency and bankruptcy matters be consulted concerning these issues. Rules appropriate for wills and common law trusts may be appropriate for insolvencies and bankruptcies, but someone should so conclude after a thoughtful analysis.

It is respectfully requested that the American Law Institute direct the reporters to specifically consider the impact of the proposed rules on insolvency and bankruptcy practice as well as the representation of those in control of financially distressed entities.³⁷⁷

The Business Bankruptcy Ethics Committee presented a panel discussion for the Business Section of the American Bar Association at the Annual Meeting of the American Bar Association in August of 1995. Participants included Professor Charles W. Wolfram, Reporter for the *Restatement*, and Professor Geoffrey C. Hazard, Jr., the Director of the American Law Institute and the Reporter for the ABA Model Rules Project.³⁷⁸ The papers presented reviewed the current *Restatement* draft of conflicts rules and questions were raised as to how these rules applied in reorganization cases. Participants suggested that bankruptcy did not fit the model of bilateral civil litigation.

Bankruptcy reorganization represents a hybrid of administration and litigation. Should the civil litigation conflict rules or the non-litigation

377. Memorandum from Gerald K. Smith and David A. Murdoch, Chairs of the Ethics Subcommittee and Subcommittee on Committees, Trust Indentures and Claims Trading of the Business Bankruptcy Committee of the Business Section of the American Bar Association, to Professor Charles W. Wolfram, Reporter for *Restatement (Third) of the Law Governing Lawyers* 3-6 (May 11, 1994) (on file with author).

378. The Ethics Subcommittee was represented by its then Reporter, Susan M. Freeman, its then Vice Chair, Mitchell A. Seider, and one of its members, Jeffrey C. Krause. The papers prepared for the panel discussion by the members of the Subcommittee dealt with conflicts of interest, potential liability of counsel for the debtor-in-possession and when it is permissible to divulge confidential information in bankruptcy cases. Professor Hazard also prepared a paper outlining the obligations of counsel for a debtor in bankruptcy.

conflict rules apply to counsel proposing to file a bankruptcy petition? What is a conflict? The goal of reorganization is better treatment for creditors and equity holders than would be available upon a liquidation of assets. The interests of creditors, equity and the debtor are in principle aligned as to that goal. But the mere filing of a bankruptcy petition hinders the ability of creditors to collect their debts, and enables the debtor to reject outstanding contracts and to recapitalize in a manner which may drastically affect equity security holders. Alliances between debtor management, creditor and equity may vary issue by issue during the case.³⁷⁹

In 1995, the NBC was heard from. Earlier that year, the chair of the NBC directed its Ethics Committee to review ethical rules governing lawyers in bankruptcy cases. In a communication on behalf of the NBC to Professor Wolfram in October of 1995, concern was expressed as to "whether a lawyer representing creditors, stockholders or owners of a debtor in unrelated matters can represent the debtor or other creditors, stockholders or partners in connection with a bankruptcy case"³⁸⁰ under the conflict provisions of the *Restatement*. It was pointed out that the limited discussion of bankruptcy matters in Chapter 8 of the *Restatement* suggested that a bankruptcy case is a variety of civil litigation. If that is so, did the Reporters intend to preclude a lawyer "from filing a bankruptcy case, assuming no consent, if a creditor, partner or stockholder of the debtor is a client of the lawyer as to unrelated matters?"³⁸¹ Professor Wolfram's response of November 21 and his subsequent letters of November 27 and December 6, 1995 made it clear that Professor Wolfram viewed the filing of a bankruptcy case as the commencement of civil litigation.

The NBC held its spring meeting in March of 1996. At that meeting, the Conference directed its Committee on Professional Responsibility to continue discussions with the Reporters and Director Hazard and to urge

that Chapter 8 of the *Restatement* be clarified to make clear that conflict of interest principles designed to address non-bankruptcy "civil litigation", such as those contained in Section 209, should not automatically be applied to the entirety of a bankruptcy case. While the conflict of interest principles applicable to civil litigation may properly be applied to an adversary proceeding or contested matter where the debtor, trustee or

379. Geoffrey C. Hazard, Jr. et al., *Restatement of the Law Governing (Bankruptcy) Lawyers-Bankruptcy Concerns Raised by the Draft American Law Institute Restatement of the Law Governing Lawyers*, paper presented by the Business Section Panel at the Annual Meeting of the American Bar Association (Aug. 1995).

380. Letter from Gerald K. Smith to Professor Charles W. Wolfram 1 (Oct. 18, 1995) (on file with author).

381. *Id.*

creditors' committee is asserting or defending against a claim, it should not be presumed that bankruptcy counsel is materially adverse to individual stakeholders with regard to other matters in the case. The appropriate section of the *Restatement* under which such other matters should be tested is Section 201, which requires a determination of the actual risk of material adversity.³⁸²

Professor Wolfram responded that:

We addressed the bankruptcy issues under § 209 in its *Comment d(iii)* on pages 662-63 of Proposed Final Draft No. 1. We there specifically refer to the fact that the context of multi-party litigation such as bankruptcy must be examined before assessing whether a conflict exists. That seems to be the same point made in the position paper. I'm curious to know in what way the two positions don't agree. The position paper is, of course, far more elaborate (although it remains at a very high level of generality), but our effort in the Proposed Final Draft has been to avoid getting into great detail on any practice area.³⁸³

In a Memorandum of May 2, 1996 NBC Conferee Donald S. Bernstein suggested additional commentary.

I have looked at *comment d(iii)* to Section 209 of the *Restatement* (referred to by Wolfram in his letter to you). If I understand the *comment d* correctly, the whole comment relates only to determining whether there is a conflict when simultaneously representing in a single litigation multiple clients "nominally on the same side." It appears to me that the issues we have raised are really more like the issues raised in *comment e* ("Suing present client in unrelated matter.")

Because of the oversimplified "plaintiff vs. defendant" model of "civil litigation", this comment does not address civil cases which, like bankruptcy, where parties who are adverse as to some issues are not materially adverse with respect to numerous others.

Perhaps we should suggest a new *comment e(i)*:

e(i). Proceedings Involving Multiple Parties in Disparate Controversies. Certain types of civil proceedings, such as bankruptcy cases, may involve multiple parties and multiple disputes. While Section 209 (2) addresses the lawyer's role in asserting or defending against a claim made by one client against

382. Memorandum from the Committee on Professional Responsibility of the National Bankruptcy Conference to Professor Charles W. Wolfram 4 (Apr. 18, 1996) (on file with author).

383. Letter from Professor Charles W. Wolfram to Gerald K. Smith (Apr. 24, 1996) (on file with author).

another in the context of such a proceeding, a lawyer is not disqualified from representation of a client in such a proceeding with respect to other matters where material adversity does not exist.³⁸⁴

At the same time, Susan M. Freeman suggested to Professor Wolfram a specific amendment to comment d(iii) to section 209 of the *Restatement* and the Reporter's Note to Professor Wolfram:

d(iii). Complex and multi-party litigation. Not all possibly differing interests of co-clients in complex and multi-party litigation involve material interests creating conflict. Determination whether a conflict of material interests exists requires careful attention to the context and other circumstances of the representation and in general should be based on whether (1) issues common to the clients' interests predominate, (2) circumstances such as the size of each client's interest make separate

384. Memorandum from Mr. Bernstein. to Gerald K. Smith (May 2, 1996) (on file with author). Subsequently, Mr. Bernstein articulated additional reasons why he believed the bankruptcy case as a whole should not be subject to the bilateral litigation rule:

I do not see the bright line distinction between the pre and post-filing period In business reorganization (chapter 11) cases, most of the disputes between clients will be the same ones that existed prior to bankruptcy in the context of efforts to restructure out of court: are the claims valid, are the liens good, how should the company's debt be scaled back, how much equity should the old equity holders retain. Although after the filing the court will be involved in determining whether these disputes give rise to a conflict (because the court must approve retention of counsel by the DIP), from the lawyer's perspective, the potential disputes have not, in the main, changed.

This leads me to ask why, if the treatment of creditors is still the subject of negotiation rather than litigation, the ground rules should change by virtue of the fact that the debtor comes under court supervision by filing a petition. One might take the view, instead, that if the per se civil litigation rule did not apply to pre-bankruptcy situation, the fact of the filing should not change this unless and until the issues between the parties degenerate into litigated disputes in the case. Prior to that time—and in the pre-filing context as well—the general rules stated in Sections 201 and 209(1) should apply. There may well be a conflict, but it is *not* generated by the pendency of the bankruptcy case. It is generated, if at all, because the parties are on opposite sides of the table trying to resolve disputes in a negotiated restructuring.

Maybe we haven't been clear on this point because it is so intuitive to those of us in bankruptcy practice: *most chapter 11 cases are in the eyes of bankruptcy practitioners continuation of an out of court restructuring transaction.* The fact that a bankruptcy proceeding has been commenced does not mean, at least to the bankruptcy lawyer, that all aspects of the relations between the parties have become the subject of litigation.

Memorandum from Donald S. Bernstein to Professor Charles Wolfram 1-2 (Oct. 3, 1996) (on file with author).

representation impracticable, and (3) the extent of active judicial supervision of the representation. *Further, the fact that one client merely holds a claim against the other client in a judicial proceeding is not "assertion" of a claim for conflict purposes. A claim is "asserted" or "defended" when a dispute concerning the claim is resolved.* For example, a lawyer might represent several unsecured creditors in a bankruptcy proceeding. In addition to general conflict of interest rules that may apply, a lawyer representing such multiple clients must also comply with statutory regulations if more stringent.

. . . [comment continues with discussion of class actions]

REPORTER'S NOTE *Comment d(iii)*. Add a citation to *In re Amdura*, 121 B.R. 862 (Bankr. D. Colo. 1990) and 139 B.R. 963 (Bankr. D. Colo. 1992) after *In re Aircraft Instrument & Dev., Inc.*, 151 B.R. 939, 943-44 (Bankr. D. Kan. 1993).³⁸⁵

Ms. Freeman's explanation for the proposed changes focused on what she believed was the Reporter's position:

"[A]sserting" and "defending" a claim for conflict purposes means litigating over the claim. Merely holding or filing a claim is not deemed "asserting" it. This matters.

As the Restatement comment properly notes, resolution of conflicts in bankruptcy depends on the interpretation of bankruptcy statutes and rules in addition to lawyer code provisions and judicial decisions. The Bankruptcy Code does not prevent all representation of debtors in possession and trustees when the lawyer's firm represents a creditor. 11 U.S.C. § 327(c). In some circumstances, the creditor may hold such a minimal interest that representation of the debtor or trustee would not "be materially and adversely affected by the lawyer's duties to [the creditor] client in the matter," in the words of Restatement § 209. However, if the mere holding or filing of a claim or interest is considered "asserting" it, under the Restatement prospective counsel for a debtor or trustee still must obtain the informed consent of each creditor client before he can take on the debtor or trustee representation. The same would be true for representing a defendant in a class action context, where firm clients are likely class members. This may be extremely impractical in a large case, especially since Restatement § 202 comment c states that the requirement of consent generally requires an affirmative response by each client, and that counsel cannot just assume consent from client acquiescence.

The size of the claim by the creditor client is a factor in determining whether there is a substantial risk of material adversity in a bankruptcy case, wholly apart from whether separate representation is impracticable.

385. Draft Accompanying Letter from Susan M. Freeman to Professor Charles W. Wolfram 1 (May 3, 1996) (on file with author).

Thus, the phrase in the comment about the size “mak[ing] separate representation impracticable” should be deleted. Second, a citation to the *Amdura* case would be useful, since it discusses at length the application of Restatement criteria to a single law firm’s representation of a debtor in possession and a creditor, while the *Aircraft Instrument & Development* case cited for that issue concerns an accounting firm instead of a law firm, and includes a discussion of lawyer restrictions on conflicts being inapplicable to accountants.

Finally, the reporters’ understanding about the meaning of “asserting” a claim should be expressly set forth, since courts and attorneys could reasonably understand that a creditor client’s invoices or letters demanding payment or filing of a proof of claim would be “asserting” a claim. If “assertion” and “defense” of a claim instead means litigation of the claim, the intent of the Restatement provision would be met in the bankruptcy context. A law firm could not litigate against a present client in a courtroom dispute without its informed consent, no matter how small the claim. Absent claim litigation, however, whether counsel could represent a debtor in possession or trustee and, on unrelated matters, creditors or other parties in interest, would depend on whether there was a substantial risk that representation of one would be materially and adversely affected by the lawyer’s duties to the other in the case.³⁸⁶

Professor Wolfram immediately responded with a proposed text for the first paragraph of Section 209, comment d(iii), based on Ms. Freeman’s draft and earlier suggestions of Professor Wolfram.

d(iii). Complex and multi-party litigation. Not all possibly differing interests of co-clients in complex and multi-party litigation involve material interests creating conflict. Determination whether a conflict of material interests exists requires careful attention to the context and other circumstances of the representation and in general should be based on whether (1) issues common to the clients’ interests predominate, (2) circumstances such as the size of each client’s interest, and (3) the extent of active judicial supervision of the representation. *For example, in a bankruptcy proceeding, the fact that one client holds a claim against another client is not necessarily “assertion” of a claim for conflict purposes. A claim is “asserted” or “defended” when a dispute concerning the claim is involved. On the other hand, when there is no substantial likelihood that the proceeding will devolve from administration of the estate into contested proceedings between two or more clients, no adversity is ordinarily involved as between the clients and hence no conflict of interest is present.* In addition to general conflict of interest rules that may apply,

386. *Id.* at 1-2.

a lawyer representing such multiple clients must also comply with statutory regulations if more stringent.³⁸⁷

Several drafting matters were then considered, along with a substantive point raised by Mr. Bernstein.³⁸⁸ A final draft of agreed amendments to the Commentary to section 209 was achieved on May 9, 1996:

Amendment No. 1—§ 209, Comment c

(1) Change the heading of present Comment *c* (Proposed Final Draft, page 659) to read as follows: *c(i) Clients aligned in opposition to each other—in general.*

(2) Add a new Comment *c(ii)* at the end of the present Comment *c* (Proposed Final Draft, page 660), to read as follows:

c(ii). Opposing client in multi-party litigation. Certain types of civil proceedings, such as bankruptcy cases, may involve multiple parties and multiple disputes. The fact that one client holds a monetary claim against another client in a bankruptcy proceeding is not necessarily “assertion” of a claim for purposes of this Section. A claim is “asserted” or “defended” when a dispute concerning the claim is involved. When there is no substantial likelihood that the proceeding will devolve from administration of the estate into contested proceedings between two or more clients, no conflict of interest under this Section is ordinarily present as between the clients. Further, a discrete conflict between two clients, such as a dispute over the validity of a claim in a bankruptcy proceeding, may not disqualify a lawyer from

387. Letter from Professor Charles W. Wolfram to Susan M. Freeman (May 3, 1996) (on file with author). The suggested language “when there is no substantial likelihood that the proceeding will devolve from administration of the estate into contested proceedings between two or more clients, no adversity is ordinarily involved as between the clients and hence no conflict of interest is present,” came from Director Hazard. See Letter from Professor Charles W. Wolfram to Gerald K. Smith (May 3, 1996) (on file with author).

388. See Memorandum from Susan M. Freeman to Professor Charles W. Wolfram (May 6, 1996) (on file with author).

I sent Don Bernstein your Friday letter to me for his review. He appropriately points out that in bankruptcy cases, courts may allow counsel to represent a debtor in possession even when there is a known conflict with an existing creditor client. The court may simply have other special counsel (authorized under § 327(e)) or committee counsel handle that portion of the case. The *Amdura* case I referred you to addresses a proposal to do precisely that. The court held in that case that the creditor client’s role in the case was so pervasive and critical that special counsel wouldn’t work. In other cases, it will work. E.g. *In re Blinder, Robinson & Co.*, 131 B.R. 872, 880 (D. Colo. 1991); *In re Lee Way Holding Co.*, 102 B.R. 616 (S.D. Ohio 1988). The court will look to the materiality of the conflict from the perspective of the case as a whole.

Id.

representing one client with respect to aspects of the case not involving the dispute between the clients. In addition to general conflict rules that may apply, a lawyer must also comply with statutory regulations if more stringent, such as provisions of the bankruptcy code.

Amendment No. 2—§ 209, Comment d(iii)

Amend the first paragraph of § 209, Comment *d(iii)* (Proposed Final Draft, page 662) to read as follows:

d(iii). Complex and multi-party litigation. Not all possibly differing interests of co-client in complex and multi-party litigation involve material interests creating conflict. Determination whether a conflict of material interests exists requires careful attention to the context and other circumstances of the representation and in general should be based on whether (1) issues common to the clients' interests predominate, (2) circumstances such as the size of each client's interest, and (3) the extent of active judicial supervision of the representation. Among other considerations, assessment of the existence of a conflict should take into account the requirements of materiality (*see* § 201 & Comment *c(ii)* thereof) and substantial risk (*see id.* & Comment *c(iii)* thereto) of conflict. In addition to general conflict of interest rules that may apply, a lawyer representing such multiple clients must also comply with statutory regulations if more stringent.³⁸⁹

Unanticipated opposition to the proposed amendments was voiced by Judge Caroline D. King at the annual meeting of The American Law Institute.³⁹⁰

Judge Carolyn Dineen King (Tex.): Yes. I think, if I understand this correctly, that I do object. You will note that § 209 is broken down into Subsection (1) and Subsection (2), Subsection (1) precluding the representation where you "represent two or more clients . . . if there is a substantial risk that the lawyer's representation of one of the clients would be materially and adversely affected by the lawyer's duties to another client" and Subsection (2) dealing with representing "one client in asserting or defending a claim against another client . . . represented by the lawyer."

389. Proposed Text of Amendments Accompanying Memorandum from Professor Charles Wolfram to Gerald K. Smith, Susan M. Freeman, and Donald S. Bernstein (May 9, 1996) (on file with author).

390. A member of the American Law Institute's Council and Judge on the Fifth Circuit Court of Appeals, and next in line to be the Chief Judge of the Fifth Circuit.

Now, if you take a look at the language that is proposed in this amendment, it starts out as if it were addressing Subsection (2). It says "The fact that one client holds a monetary claim against another client in a bankruptcy proceeding is not necessarily 'assertion' of a claim" And then it says, "A claim is 'asserted' or 'defended' when a dispute concerning the claim is involved," and that looks as if it is addressing the second part of this § 209. But then it goes on to say where "there is no substantial likelihood that the proceeding will devolve from administration of the estate into contested proceedings between two or more clients, no conflict of interest under this Section is ordinarily presented," which of course takes Subsection (1) out of play also. So I am not altogether sure that was intended, but that is the effect of it. I know that the bankruptcy lawyers have assiduously pursued the proposition that they would like to be carved out of this Restatement, and we have, I think quite properly, resisted that, and I hope we will to our dying day. But I believe that, with the way this has been drafted, they have been carved out.

And the next sentence doesn't give me any more comfort because it says, "a discrete conflict between two clients, such as a dispute over the validity of a claim . . . , may not disqualify a lawyer from representing one client with respect to aspects of the case not involving the dispute between the clients."

I would like to make the point here that there is a fundamental problem with what we are doing here, and that is there are two ways in which a claim can be adversely affected in a bankruptcy proceeding. One is at the end of the day, so to speak, when we will adjudicate, most often at the end of the day, whether it is valid, whether it is secured, whether it is subordinated, and so on, all right, and you can be killed if you are a claimant at the end of the day. But you can be equally as dead by virtue of the way that claim is treated under the plan. And you draw a distinction in your language here between the administration of the case, which sounds like sort of bookkeeping but is in fact where the heavy lifting is done in a bankruptcy case. So my suggestion is that it is naive, I think it looks naive, to buy into this distinction.³⁹¹

The following colloquy then took place between Professor Hazard and Judge King:

Director Hazard: Well, I mean if you say once bankruptcy is filed, then you have to treat it as though all claimant positions are hostile in a disqualifying sense to the debtor.

Judge King: Right.

391. Transcript of Debate over Amendments to Section 209 of the Restatement of the Law Governing Lawyers at the 1996 Annual Meeting of the American Law Institute, *in* 73 A.L.I. PROC. 389 (1996).

Director Hazard: Is that the position you would take? So that, if you represent anybody who is a claimant, you cannot represent the debtor?

Judge King: I think that that is—

Director Hazard: That is the crunch that they are worried about.

Judge King: I know. I know that is the crunch. Let me say that is the crunch they are in today, all right.

Director Hazard: I understand.

Judge King: So we have now what I think the bankruptcy lawyers view as an opportunity to get out of the crunch that they are currently in, and I would say let's be very careful about that.

Director Hazard: Well, I agree with that, but I have to say the word "administration" was my word, and I take responsibility for it. I had in mind that there are lots of bankruptcies where it is to a large extent a bookkeeping matter, . . . but the question is, is there a way you can describe a stage prior to, how shall we say, a prelitigation or a precrunched stage where you would feel more comfortable saying, "Well, you can go that far but you've got to stop." I am questioning do we have any words that can describe the boundary?

Judge King: I don't at this point. I think the thing needs to be rethought. I mean, I really think it needs to be recommitted. The problem is that in many prepacks all of this stuff gets worked out ahead of time, but those present their own problems, too. I think that may be what you are talking about.³⁹²

Professor Wolfram joined in.

Professor Wolfram: Judge, at least as I understand it — but I will let the bankruptcy people, if there are any here, speak for themselves, — it was a sub (2) problem, their problem. They simply didn't want to be in the position of being tagged with the sub (2) disqualification, even though they were clean under sub (1), just because bankruptcy is thought to be adjudication, and that was the point of treating it as administration devolving into dispute.

. . . .

Professor Wolfram: But as I understand it, your problem is that when you prepackage things, for example, the negotiation that goes into that is where the hostility is.

Judge King: That's right.

Professor Wolfram: The fact that it is all sweetness and light by the time it comes to court doesn't mean there was never a conflict.

Judge King: That's right.

392. *Id.* at 391.

Professor Wolfram: I quite agree with that, but I wonder whether that isn't a sub (1) problem and adequately covered by sub (1).

Judge King: I am really not sure, because when you have a claim in one of these proceedings, the question that you have is it plays out in such ways that you can't see vis-a-vis the way in which the debtor is administered, the way in which the plan is confectioned

Professor Wolfram: Well, I see the problem, and I think I take your point, that it might be well if we went back to possibly a larger group in which you would be included — if I may suggest that — to negotiate this further. But I think that, under sub (1), the kind of problem that you are worrying about could be dealt with. Possibly it can't be dealt with in a way that judges would want it dealt with, that is to say, to have bright-line rules disqualifying. It is really a rule that permits the unwinding of the representation later with inspection into whether it in fact has been appropriate in terms of adverse impact on the lawyer's representation, and it could be that simply referring, for example, as the Comment does in the last sentence here, to superadded requirements under the bankruptcy statute that might require a heightened duty, also has to be observed as insufficient.

Judge King: May I respond to that? I mean in my court, if someone asks you a question from up there, you get to respond; I don't know if that is how it works here. (*Laughter*) Even when the red light is on, you get to answer the question, and they generally say, "But only one sentence."

You have in here this reference to complying with more stringent statutory requirements, but you understand, of course, that the statute operates in significant part, not exclusively but in significant part, by incorporating the state conflict-of-interest rules. So when you do this, when you do whatever you do here, you need to understand that it will de facto amend the bankruptcy law. Okay?

Ms. Susan M. Freeman (Ariz.):

. . . .

The Bankruptcy Code in § 327(c) says that you are not disqualified from representing the debtor because your firm represents a creditor. That is not per se a disqualification, and the Bankruptcy Code specifically authorizes special counsel to come in and handle matters in a case that the attorney for the trustee or the attorney for the debtor cannot handle. This provision is intended to deal, you are correct, Professor Wolfram, with Subsection (2), in saying that the mere fact that a client in your office has a claim is not enough to disqualify you from representing the debtor or the trustee. The question is, is there going to be a dispute involving that claim, whether it is a dispute over the validity of the claim or a dispute over treatment of the claim under the plan, but those kinds of disputes you could not handle on behalf of the debtor.

And then you get to the question of, well, can you still represent the debtor if there are other claimants out there, if there is a possibility of a dispute with an existing client of your office? And then it comes down to the fact that you can depending on other rules, the Subsection (1) rules,

§ 201, where there is not a likelihood that there is going to be a significant contest, then—

....

Mr. Sheldon H. Elsen (N.Y.): I think the Director has put his finger on it. This ought to go back for more work. I speak as a nonbankruptcy lawyer who has been involved in these situations, and I think that Geoff alluded to the fact that there are institutional problems that this is intended to solve. In a large city like New York, with giant bankruptcies involving big-board companies, a situation where law firms that represent creditors, such as the major banks, would be barred from representing debtors-in-possession would be bad public policy, because these firms accumulate a high degree of expertise and skill in dealing with the problems of public companies and complex accounting and other financial problems and society, would simply be harmed if their skills could not be made available to debtors because they represent the banks.

On the other hand, these firms have, in the better situations, when the actual litigation has arisen, referred the case to special counsel. I think what Judge King is pointing to in the *Leslie Fay* case is a situation where that firm would have probably done better to have done some referrals earlier in the game, but I know the firm in question has solved that in other situations. It is immensely complex, and I do think the Director is right. It ought to go back for some further working, but I don't think you ought to throw the baby out with the bath water. The institutional solution here is socially desirable.

Mr. Brian Redding (Ill.): I have great sympathy with the practical problems that Ms. Freeman articulated and also with Judge King's comments. Having wrestled with this a bit, one of the things I might suggest that the Reporters might think about if, as seems likely, they are going to do more work on it, is the consent problem. When I talk to bankruptcy lawyers one of the enormous problems here is the practical problem of getting consent from a huge number of clients of your law firm who are representing creditors, and, in the short run, sometimes in some courts the bankruptcy judge can be of assistance on that. I think maybe, as you discourse with the bankruptcy folks, maybe you ought to think about whether there isn't a way to help solve the problem by relaxing consent in terms of doing consent through the court rather than the kind of consent that we are all used to, individualized consent with individualized contact back and forth through a client list that may include 75 or 100 or 200 creditors in a given bankruptcy.

Vice President Traynor: Do the Reporters wish to respond briefly?

Professor Wolfram: I think I am sympathetic to the motion, which I understand to be a motion to recommit for further consideration, but I don't wish to withdraw the matter from the floor. We are on the tipping point of a vote which I think is inevitable in any event.

Vice President Traynor: Judge King, do you wish to take a minute to respond?

Judge Carolyn Dineen King (Tex.): I think recommitting this is the thing to do. I am very sympathetic to the problem, and I want very badly to see this problem taken hold of by the horns and fixed. I think Mr. Redding's comments go right to it, but I don't want to see something like this. I would rather see us tackle the whole thing head on instead of trying to do something like this, so I think recommitting it is what I would espouse.³⁹³

Judge King's opposition doomed the proposed amendments and resulted in the recommittal of section 209.

As a result of discussions and correspondence among those concerned, including Judge King, Council Draft No. 13 reflects changes to the commentary to section 209.

c(ii). Opposing clients in multi-party litigation. Certain types of civil proceedings, such as bankruptcy cases, may involve multiple parties and disputes. There is substantial disagreement whether various bankruptcy proceedings should be considered under Subsection (2). Tribunals must resolve such questions in light of a body of decisions developed in the specific context of bankruptcy, and often the issues are controlled by statute. The context involves transformation of a business relationship into one that is at least in part controlled by different principles and rules, some of them of a fiduciary nature. The Restatement takes no position on the applicability of Subsection (2) in the many situations that may arise in bankruptcy. However, "asserting or defending a claim" within the meaning of the Subsection refers to a dispute about the claim and not merely holding or filing a claim as to which there is no reasonable likelihood of dispute.

In all such situations the lawyer must comply with Subsection (1) and Section 201 generally, both before and after the filing of a formal proceeding. For example, two or more present clients of a lawyer or law firm may be involved in contentious negotiations about such issues as the validity, amount, or priority of claims, the voidability of a pre-bankruptcy transfer, or the nature of a claim as secured or unsecured. Whether a conflict exists in such multiple representations must be analyzed under Subsection (1) (see also § 211). In addition to general conflict rules that may apply, a lawyer must also comply with statutory and regulatory requirements if more stringent, such as applicable provisions of the bankruptcy code.

A dispute between two clients—either before or after filing of a bankruptcy proceeding—may not disqualify a lawyer from representing one client with respect to aspects of the matter not involving that dispute. For example, as may be true in other contexts as well, a separable disputed

393. *Id.* at 391-95.

matter may be handled by one or more special counsel not affiliated with the lawyer or law firm in question (see § 203).³⁹⁴

The National Bankruptcy Review Commission has an innovative way of dealing with the work of the Commission. The Commission has obtained the assistance of an outstanding lawyer and two outstanding law professors.³⁹⁵ This has enabled the Commission to create working groups to intensively review specific areas of concern to the Commission. One of the working groups is the Working Group on Ethics.³⁹⁶ The participants in the Working Group have met several times³⁹⁷ and have recommended (1) that the standard for employment of professionals by the debtor-in-possession should be the predominant state rule as restated in the current draft of section 201 of the *Restatement* and (2) those admitted to practice in any bankruptcy can appear in cases in other bankruptcy courts.³⁹⁸

394. *Restatement (Third) of the Law Governing Lawyers* (Council Draft No. 13, 1996), pp. 36-38. The Reporter's Memorandum accompanying Council Draft No. 13 stated that, after extensive discussion and correspondence it was decided not to deal explicitly with bankruptcy. "That field is characterized both by specific statutory limits that, at least as frequently interpreted, apply conflict rules more exacting than those normally imposed on lawyers and that are the subject of study for possible legislative modification." *Id.* at xxiii. The Memorandum went on to summarize the substance of the revisions to Comment *c(i)* and *c(ii)* as follows:

Comment c(i). The text of the Comment is the old Comment c, relettered, with the addition of the final two sentences. Those sentences note that the rule of Subsection (2) applies even if the litigations are unrelated and notes that the rule applies without the situation-specific inquiry that Subsection (1) may in other contexts require.

Comment c(ii). The Comment is a substantially reworked version of the amendment that was debated last May. The text has been extensively reviewed and reworked in light of comments from several Members and a helpful interested Council member. As will be seen, the *Restatement* takes no position on the specifics of bankruptcy conflicts for the reasons indicated above.

Id. at xxiii.

395. Reporter Elizabeth F. Warren, a Professor at Harvard University, and two senior Advisers, Professor Lawrence P. King of New York University School of Law and Stephen H. Case of White & Case.

396. It consists of Commissioners Ginsberg and Butler and Senior Adviser Professor Lawrence P. King. The member of the staff assigned to the Working Group is Elizabeth Holland, Esq.

397. Meetings were held July 18-19, 1996, Washington, D.C., September 18, 1996, Santa Fe, NM, December 17, 1996, Washington, D.C., and January 22-23, 1997, Washington, D.C. Participants included Don Bernstein, Michael Bloom, Susan M. Freeman, Bernard Shapiro and Gerald K. Smith.

398. Memorandum from Professor Lawrence P. King and Elizabeth I. Holland to the National Bankruptcy Review Commission (Feb. 13, 1997).

Admission to practice in one bankruptcy court, usually by virtue of being admitted to practice in the relevant United States District Court, should entitle an attorney, on presentation of a certificate of admission and good standing in another district court,

The decision to recommend the elimination of the disinterestedness standard as to professionals employed by the debtor-in-possession was unanimous and reached early on. And it naturally followed from this recommendation that guidance be furnished as to disqualifying conflicts. The definition in section 201 of the *Restatement* has received general acceptance and those involved believed it should be adopted as a statutory definition of adverse interest.

Another issue considered by the Working Group was whether the Bankruptcy Code should adopt its own rules of professional conduct governing lawyers appearing in bankruptcy courts which preempt state rules. The Working Group tentatively concluded that the Bankruptcy Code should not do so. The result would be a continued lack of uniformity. A national practice will not be regulated by uniform, national rules as far as the important matter of disqualifying conflicts.³⁹⁹ Although perhaps not constitutionally mandated,⁴⁰⁰ the lack of uniformity is genuinely troublesome. Unfortunately, because of the opposition of one of the members of the Commission, Judge Jones, it appears that the Commission will not make any significant or useful recommendations concerning conflicts.⁴⁰¹

to appear in the other bankruptcy court without the need for any other admission procedure. The proposal will not affect requirements (if any) to associate with local counsel. Similarly, the proposal will not change the requirements under state law governing the practice of law and the maintenance of an office for the practice of law. The proposal will only amend the local bankruptcy rule or practice requirements governing special admission of attorneys to the bankruptcy court who are otherwise not admitted to the bar of the district court in the district where the bankruptcy court is located.

Id. at 1-2.

399. Also troublesome is the preliminary indication that the Commission will recommend a national admission policy, but will not recommend that local rules requiring local counsel are unfavorable. Although it is often essential to have local counsel, it should not be mandated. There are many situations where local counsel is unnecessary.

400. See U.S. Const. art. I, § 8, cl. 4. This clause of the Constitution authorizes Congress to enact "uniform laws on the subject of Bankruptcies throughout the United States." *Id.*

401. The following are excerpts from the hearing of the Commission in Detroit, Michigan, the morning of June 19, 1997.

Hon. Hollan-Jones: All right. Thank you. Thank you Mr. Chairman.

I would like to restate what I think came out at our plenary discussion in May, but I'll try to be brief.

I've written [sic] a memo on this on April 21st. I was pleased to see I got a little bit of support at least from a letter from the Executive Office of the U.S. Trustees for which I am grateful.

Disinterestedness is a concept that's been in the Bankruptcy Code for 60 years. I think anybody who would seek to change it and to reflect what I consider is a lessening or watering-down of the ethical standards for practice in the Bankruptcy Court. At this time in our history, it bears a very heavy burden of proof and in my view the reasons advanced for changing this standard do not bear that burden.

I think we can all agree that there are just a few discreet problems to which this concept of disinterestedness applies a legitimate context. One of them would seem to be and most of these problems are taken from the August memo prepared by Professor King and Ms. Holland.

One of those problems is that of the attorney who is also a pre-petition creditor or perhaps a shareholder or perhaps a has some other particular role in the debtor company. A second is the attorney who represents a small Chapter 11 company in which the interest of the proprietor and the debtor company are basically one and it is wholly impractical to apply strict disinterestedness and say that two different lawyers have to be retained in that representation.

We can solve the first one without problem easily, and I've circulated a letter on that subject, without changing the disinterestedness requirement. We would simply modify 1107(b) to say that an attorney shall not, per se, be disqualified because he holds or represents as nominal or insubstantial or small pre-petition unsecured debtor equity interest in the debtor.

The second problem, that of the attorney who represents both the proprietor and the small business is a lot tougher nut to crack, and to be honest I have not found an outright solution that yet.

What I will say about this proposal is that in doing away with the disinterestedness standard and going with the material adverse standard, we are using a sledge hammer to swat the fly which consists of these discreet problems. And, indeed, the impact of doing away with disinterestedness is going to be much broader and I do believe that the major impact of that will be to protect and assist larger firms in the bankruptcy area who regularly represent creditors on one floor of their operation, debtors on another floor and vulture lenders somewhere way up at the top of the building.

There is very little justification for that permitting such dual representation to occur. And that if you go to the material adverse interest standard, it is certainly a possibility.

The proposal defines—redefines conflicts in bankruptcy to accord with standards set by the ALI and the ABA for transactional attorney representation. Heretofore, at least in bankruptcy lore, attorney ethical standards have been governed by the litigation model of ethics which says that if you represent one party to a controversy which is in a lawsuit, you may not represent a competing party. The argument in favor of the proposal is that, well, in bankruptcy what we really have is transactions and people are basically doing deals to effectuate a reorganization.

The counter argument which I think is much more powerful consists of several parts. First of all you have a debtor in possession who is a self-interested party by definition. Not as much a fiduciary for the creditors' rights as the old Trustee under Chapter [X] was. You need to have some party ethically mindful of the fact that this is—the debtor in possession is a fiduciary for the creditors and not simply self-interest for the debtor's equity and management.

Second, there is more of a litigation than a transactional cast to this kind of representation because you have parties who are friendly—copacetic when the bankruptcy proceeding starts out, but bankruptcy being a multi-party transaction or dispute or whatever, their interests as one gets closer to the date of formulating a plan, are going to come into focus more clearly and quite often will be opposed to each other.

Well suppose you have a firm that has persuaded some judge that it can represent the debtor on one floor and it's going to represent this creditor on the other floor, can

The Advisory Committee on Bankruptcy Rules had considered the ABA House of Delegate Resolution and materials prepared by the Ethics Subcommittee of the Business Bankruptcy Committee and concluded that substantive changes were proposed which were outside the authority of the Committee. Nothing further happened until the Spring of 1995, when Judge Paul Mannes, the then Chair of the Advisory Committee on Bankruptcy Rules, created a Subcommittee on Ethics and Disclosure.⁴⁰² The name of the

anyone really say that that firm is going to be single-minded pursuing the interest of either client throughout the bankruptcy? I think the answer suggests itself. Leslie Fay I think is the perfect example of where perhaps good intentions were totally awry. Where the debtors' counsel thought they could represent two of these accountants who were being investigated in a separate matter, and guess what, it didn't work and they ended up concealing material information from the creditors and potentially depriving their client of some valuable claims.

So I really don't think that watering-down disinterestedness when it leads to this kind of possibility is a very good thing to do. I think it's highly imprudent to suggest it to Congress when lawyers and the ethics we practice are currently under attack generally speaking. And on the other hand, I do think of narrower proposal, at least solves one of the major problems and I'm open for discussion about solving the other problem. Perhaps through the context of our small business bankruptcy proposal.

....

Prof. King: I just want to add that just focusing on the disinterestedness proposal itself, it really does not change or is meant to change 60 years of practice. Because under the former act, if we look at Chapter [XI], there was no disinterestedness requirement for an attorney for a debtor in possession. Under Chapter [X] where disinterestedness was as requirement because you had a disinterested Trustee that was required and therefore you had a disinterested attorney that was required, nevertheless, if you had a Chapter [X] case in which the debtor was retained in possession, there was no Trustee, the attorney for the debtor in possession did not have to be disinterested.

....

Hon. Hollan-Jones: But I'm saying, under the current law, that would be -- if you are a prepetition creditor, you are supposed to be disqualified. Now some of the cases have opened up some territory in that area. But you are supposed to be disqualified under a disinterestedness standard.

And all I'm saying is just 1107, the first sentence there, I just modeled it after the first half of the sentence. You're not disqualified solely because you were previously employed.

So now all I'm saying is I'm opening it up a little more. I'm saying you're not disqualified solely because you're the holder of, you know, I don't care what you call it. You can call it a twinkie's unsecured claim. As long as we define it in some term that's not wholly open-ended.

I thought about the word "immaterial" or "small" or, you know, "picayune", "nugatory".

402. The members of the Subcommittee included the author, Honorable Alice M. Batchelder, Honorable Donald E. Cordova, Honorable Robert J. Kressel, Kenneth N. Klee, Esq. and Leonard Rosen, Esq.

subcommittee was later changed to the Subcommittee on Rule 2014 Disclosure Requirements.

After several meetings, the subcommittee, with the assistance of Professor Alan N. Resnick, the Reporter for the Advisory Committee on Bankruptcy Rules approved a preliminary redraft of Rule 2014 which (1) revised the required disclosures, (2) required the professionals to state under penalty of perjury that the professional is eligible for employment under the Bankruptcy Code, (3) provided for an interim order of employment when necessary and (4) required a supplemental verified statement to be filed when a person employed learns or discovers additional matters of the type required to be disclosed. The proposed rule is an improvement over the present rule, but it is still in preliminary form. It will be considered at the September 1997 meeting of the Advisory Committee on Bankruptcy Rules.

The possibility of bankruptcy rules of professional conduct is alive. The Disclosure Subcommittee of the Advisory Committee on Bankruptcy Rules will explore this possibility with the assistance of Professor Coquillette, the Reporter for the Standing Committee.

There is considerable uncertainty as to conflicts of interest in bankruptcy cases. Although the focus of this article has been on reorganization cases, the uncertainty extends to bankruptcy cases under other chapters as well. Sound, clear rules are needed. Clear rules were provided by the disinterestedness standard in Chapter X cases, but changes are needed in the wake of Congressional abandonment of the disinterested trustee. The disinterestedness standard is appropriate if a disinterested trustee is appointed, but it is not for professionals employed by a debtor-in-possession. Particularly troublesome is the idea that disinterested counsel for the debtor-in-possession can somehow fill the vacuum created by the abandonment of the disinterested trustee.

The disinterestedness standard has been imposed by the courts on counsel for the debtor in possession as a result of the inept draftsmanship of the 1978 Code. The elimination of this standard of employment of professionals by the debtor-in-possession is long overdue. Use of the definition of conflict developed in the *Restatement* will be of help to the bench and bar by focusing on the correct issue, the adequacy of the proposed representation. It should eliminate the troublesome concepts of potential conflicts and appearance of impropriety. Instead, the bankruptcy judge will determine whether the representation will be adversely affected. In making that determination, the court should consider the entirety of interests of counsel, both personal and representational.

There is also a need in bankruptcy cases for clear, uniform rules relating to the other side of the coin. The recommendations of the Commission may act as a catalyst, but unless Congress or the Advisory Committee on Bankruptcy Rules adopts federal rules, meaningful change must come at the

state level.⁴⁰³ Since the American Law Institute has concluded that it will not attempt the task, this probably will occur only if the American Bar Association creates a cross-sectional task force to address conflicts in bankruptcy cases.

If the American Bar Association does take on this task, it should look to the twenty-first century, not the twentieth century. The task force should explore bright line tests and means of immediately resolving conflict issues. Clear treatment of the duty of loyalty, its meaning and scope is essential.

Even though there is not one client versus another client in a contested proceeding as in an adversary proceeding, there often is direct adversity in the sense that representation of the trustee or debtor-in-possession will require counsel to initiate contested proceedings adversely affecting other clients. An example is negotiating and confirming a plan of reorganization that adversely affects the claims of another client. Even though the other client might choose not to be directly involved in the negotiations or contested proceeding, it is nonetheless affected.

Agreements as to conflicts should be encouraged. Sophisticated clients should be able to contract as to the duty of loyalty if there is adequate disclosure and a clear warning.

The twenty-first century is nearly upon us. In the absence of reform the twenty-first century will see a significant increase in claims against professionals arising out of representation of debtors-in-possession, trustees and other parties in interest in workouts and reorganization cases. These will be based on breach of fiduciary duty and the presence of disqualifying conflicts rather than negligence.

The Bankruptcy Code is important national legislation. Congress has left its administration to the federal judiciary. When things go wrong it reflects badly on the federal judiciary. It is important that we have clear and certain rules regulating the conduct of those involved. Uniform rules would be of considerable aid as well. Conflict rules are important in this regard and how they apply to bankruptcy cases deserves thoughtful consideration.

403. As suggested in note 72 *supra*, the Office of the U.S. Trustee is a possible source of rules. However, it has opposed the reform efforts of the Working Group on Ethics and opted for the status quo.

